State Law & State Taxation Corner

By Thomas E. Rutledge

S Corp LLCs–Planning Opportunity or Solution in Search of a Problem?

Quite often I encounter businesses organized as LLCs for which an S corporation ("S corp") election under Code Sec. 1362 has been made. Sometimes these elections have been made in the context of an operating agreement that contemplates the election. At other times the election was clearly not contemplated—how else would you explain multiple classes of interests and special allocations? The consequences of the latter situation are clear—the LLC cannot both operate in accordance with its operating agreement and satisfy the requirements for S corp status. But even in the former instances, oftentimes the operating agreement does not mandate a regime that satisfies the rules for continued compliance with the rules governing S corporations.[1]

The S Corp LLC–Mixing State and Tax Law

Under the "check-the-box" classification regulations[2] adopted as of January 1, 1997, all domestic business organizations that are "incorporated" under state law are, *ab initio*, classified as "corporations."[3] On the other hand, unincorporated business organizations are "eligible entities" that may elect how they would like to be "classified" for federal tax purposes. While a corporation is automatically subject to Subchapter C and, if eligible to do so, may elect to be an S corporation, an unincorporated entity has a default classification as a partnership subject to Subchapter K so long as it has at least two owners or as a "disregarded entity" if it has only a single member. Assuming that the requirements for doing so are satis-

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fied, a business organization taxed as a corporation, as a partnership or as a disregarded entity may elect to be classified as an S corp.[4] For our purposes, typically the most troubling limitation is that an S corp may have only a single class of stock.[5]

An LLC that has either one or multiple members may elect to be classified as a corporation and from there (assuming such is permissible) make an election to be classified as an S corp. The initial election for an LLC to be classified as a corporation for tax purposes is done on Form 8832, *Entity Classification Election*.[6] If S corp status is as well desired, that election is made on Form 2553, *Election by a Small Business Corporation*.[7]

It is important to understand that one does not organize an S corp. Rather, the S corp status is elected by a business organization that is otherwise taxed as a corporation. Not only may a traditional state law corporation elect S corp status, but that same election may be made by an LLC, irrespective of whether it is a single or a multiple-member LLC, a limited partnership or any other form of business organization that, in a particular instance, satisfies the requirements for S corp status that are set forth in the Code Sec. 1361(b). As such, when the provisions of the Internal Revenue Code and its regulations discuss an "S corp," they are referring to a business organization that is taxed as a corporation and which has made an election under Code Sec. 1362 to be an S corp; there is no requirement that the organization in question had been organized as a corporation for state law purposes.

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But Why?

It is possible for an LLC to be taxed as an S corp. But just because something can be done does not mean that it should be done. Rather, this structure should be utilized only if it responds to a need, only if it resolves a particular set of problems. If it does not, it is an answer in search of a problem.

The questions presented are at least two: (a) what are the advantages of state law organization as an LLC rather than as a corporation; and (b) what are the benefits of S corp taxation over Subchapter K that warrant the election?

One aspect of the LLC that is not available in the corporate arena is the "charging order," the provision of LLC law that provides that a judgment creditor of a member may in effect garnish the distributions made by the LLC to the member, but may not otherwise insert themselves into the operation of the LLC.[8] The availability of the charging order is often trumpeted by those involved in "asset protection," who posit that the charging order makes it less likely that a judgment creditor will be able to collect and for that reason they are more likely to either abandon the claim or settle at a reduced rate. Whether such an asset protection objective should be a significant issue in the choice of entity calculus is certainly open to question.[9] Furthermore, as an asset protection vehicle, the charging order may not be effective in a single-member LLC.[10]

A perhaps more valid basis for choosing, within the context of an anticipated S corp classification election, to be organized as an LLC is the greater flexibility with respect to organizational structure. As a general rule, the corporate structure rules are mandated by the statute and are not modifiable by private ordering, rules which include the requirement that there be a board of directors,[11] that the board of directors designate at least one officer, namely the secretary,[12] that there be an annual meeting of the shareholders,[13] that there be provided a minimum of ten days notice for any meetings of the shareholders[14] and that significant organic transactions such as a merger proceed only with the approval of the board of directors.[15] While these rules are subject to a limited degree of modification in those few states that have adopted the Close Corporation Supplement to the Model Business Corporation Act, that degree of flexibility is still significantly less than that permitted under the equivalent LLC Act.

Perhaps another basis for using the LLC structure is its structural limitations upon transferability. While shares in a corporation are, absent private contracting to the contrary, freely transferable, vesting in the transferee the right to fully participate in the venture,[16] LLCs utilize the rule of *in delectus personae* pursuant to which, while the economic rights in the venture are freely transferable,[17] the right to participate in the venture's management is not

transferable.[18] By organizing as an LLC rather than a corporation, the statute provides a form of a stock restriction agreement to preclude strangers to the venture from exercising voting control. While using the LLC Act alone as a stock restriction agreement[19] is likely insufficient,[20] some may view it as a better beginning point than is the corporation statute's presumption of free transferability.

Although of limited application, another basis for choosing the LLC over a corporation may involve questions of professional regulation. Many professions may be practiced in the corporate form if, and only if, the corporation is as well subject to the professional corporation supplement in effect in the various states, which statutes have the effect of mandating certain requirements with respect to the directors and officers of the corporation, permissible shareholders and certain mandatory redemptions. In many of these states, while there is a professional service corporation supplement in place, similar limitations do not apply to LLCs that are organized to render professional services.[21]

A further possibility is state taxation. For example, until 2005, Kentucky imposed a license tax on state law corporations, even as LLCs (irrespective of tax classification) were exempt from the tax. A quick Code Sec. 368(c)(1)(F) reorganization of an S corp corporation into an S corp LLC exempted the venture from that levy.[22]

In addition to choosing the LLC format over the corporate format, there is the question of why to choose taxation under Subchapter S over taxation under Subchapter K.[23] Determining whether, at least on a *pro forma* basis, Subchapter S or Subchapter K is preferable is a rather involved process.[24] In a business in which capital is a material income-producing item, such as real estate development, often the advantages of Subchapter K will significantly trump those of Subchapter S and Subchapter C both as to the treatment of current distributions and as well the tax treatment upon liquidation.

There is often cited the distinction between Subchapter S and Subchapter K with respect to distributions. In an S corp, a certain amount of the distributions that would be made may be characterized as "salary" which is subject to FICA[25] and the balance of the funds available being treated as a distribution that is not subject to those levies.[26] Conversely, in many situations (definitive guidance from the IRS has not yet been handed down) all of the amounts distributed to an LLC member may be subject to SECA, and there is not the ability to subdivide those amounts between "salary" and "distributions."[27] All else being equal (which it never is), a shareholder employee could set a salary of $1 per year, withdrawing all other funds as distributions exempt from Social Security and Medicare taxes. Such an effort will run afoul of the ability to recharacterize income. For example, in *D.E. Watson, P.C.*,[28] the court considered a case in which a professional shareholder in an S corp was paid a "salary" of $24,000 per year. In 2003, he also received "distributions" of $175,470. The IRS successfully asserted that a portion of those funds should be classified as compensation subject to employment taxes.[29]

At the same time, it needs to be recognized that S corp classification imposes significant limitations that do not apply under Subchapter K. For example, many start-up ventures incur losses that are supported by debt financing. In the context of an S corp, failing to properly structure that debt as a personal obligation of the shareholder(s) rather than initially as an obligation of the business organization that is in turn guaranteed by the shareholder limits the deductibility of losses, as the latter format does not create at-risk basis. Conversely, in an LLC subject to Subchapter K, the guarantee of the debt undertaken by the business organization is sufficient to create at-risk basis against which losses may be taken.[30] Additionally, in the context of an organization taxed under Subchapter K, Code Sec. 754 provides planning opportunities with respect to basis step-ups on transfers of ownership interests, a planning opportunity that does not exist with respect to an S corp.

What Could Go Wrong?

Simply because something can be done does not mean it should be done, especially when the degree of complexity, and consequent risk of failure, are high. While such caveats are typically applied in the context of mountain climbing and base jumping, they can apply as well in the choice of entity calculus. Classification of a business organization as an S corp is dependent upon satisfaction of a number of conditions, some procedural, such as the timely filing of Form 2553,[31] and others substantive, such as the limitations on permissible shareholders set forth at Code Sec. 1361. Especially troubling is the requirement that an S corp be limited to a "single class of stock."[32]

Under Code Sec. 1361(c)(4), a corporation does not have more than one class of stock *solely* because of different voting rights.[33] To that end, voting and nonvoting common shares with identical economic rights in the venture have been repeatedly sanctioned as falling within the single-class-of-stock rule.

> A second class of stock generally exists if the outstanding shares do not have the same right to receive distributions and liquidation proceeds. If state law or administrative action creates a difference in the shareholders' rights to receive distributions or liquidation proceeds, a second class of stock generally exists.[34]

This requirement is particularly troubling in light of the usual statutory directive as to how assets, upon liquidation of an LLC, will be distributed. For example, the Revised Uniform Limited Liability Company Act ("RULLCA"), at Section 708(b), directs that after the satisfaction of creditor claims, the assets of an LLC will be distributed first amongst the holders of the economic rights therein as a return of capital contributed and that the balance of the assets will then be distributed *pro rata* amongst the members, dissociated members and certain transferees in accordance with the right to share in distributions.[35] This formula for the distribution of assets upon liquidation violates the single-class-of-stock rule. Shareholders who paid $100 per share will receive that amount in liquidation, while those who paid $125 per share will receive that amount. If, and only if, every shareholder paid the exact same amount for their "shares" will a second class of stock not be created.

> In addition to choosing the LLC format over the corporate format, there is the question of why to choose taxation under Subchapter S over taxation under Subchapter K.

While the operating agreement may as to the members modify the priority for liquidating distributions and the mechanisms by which operating distributions will be determined,[36] it is open to debate whether and how often S corp LLC operating agreements have effectively overridden these and similar provisions of state law.

This is not a problem, however, that exists only at the S corp LLC's dissolution, but rather exists at the time any operating distribution is made. Under many LLC acts, distributions are made in accordance with capital contributions that have been made and not returned to the company. First, keep in mind that a member's "capital contribution that has not been returned," a state organizational law concept, is, unless otherwise defined in the operating agreement, different from the member's capital account as maintained for tax purposes under Subchapter K. In the context of an S corp LLC, the unreturned capital contribution will often be different from basis in that, for example, it will not include shareholder loans. Assume, by way of example, that there is a two-member LLC. It had initially been a single-member LLC, and A was the sole member, contributing $100 in cash. Thereafter, through significant diligence, the value of the LLC increased. Several years later, B was permitted to become a member of the company, paying $500 for a 25-percent interest in the company, leaving A as the 75-percent member. A and B fully expect that all voting and economic rights will be allocated in accordance with that 75% / 25% allocation. But here we have the problem. The controlling LLC act says that all profits must be allocated and distributed in proportion to capital contributions made and unreturned, and they are in this instance, $100 by A and $500 by B, yielding a ratio of 16.66 percent to A and 83.33 percent to B. There is an obvious and manifest conflict between the requirements of the LLC Act and the single class of stock rule of Code Sec. 1361.

The writing of an effective operating agreement for an LLC that is to elect to be an S corp entails an understanding of the various requirements and limitations imposed upon S corps and a willingness to review them against the *entirety* of the controlling LLC act to determine where the LLC act provides a default rule that would or could violate the requirements of S corp status and, once those areas of conflict have been identified, the effective drafting within the operating agreement of an override provision. The transactional costs imposed in this effort are obvious, and it is questionable whether the benefits outweigh the costs and the risk.

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ENDNOTES

1 Another review of these issues appears at Robert R. Keatinge, *LLCs and Limited Partnerships as S-Corporations*, presented at LIMITED LIABILITY ENTITIES: NEW DEVELOPMENTS IN LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS (Mar. 17, 2005).

2 *See* Reg. §301.7701-1 *et seq.*

3 *See, e.g.*, Reg. §301.7701-2(b)(1). For foreign entities, the regulations list organizational forms that are treated as being incorporated and therefore, for purposes of U.S. federal income taxation, "incorporated." *See* Reg. §301.7701-2(b)(8). This treatment is consistent with what had been the law under the predecessor "*Kintner*" classification regulations. *See, e.g.*, GCM 37127 (May 18, 1977), as modified by GCM 37953 (May 14, 1979); Priv. Ltr. Rul. 79-21-84 ("[a]n entity that is 'incorporated' as that term was used at common law cannot be a partnership within the meanings of Code § 761(a) and Code 7701(a)(2)") and *Rev. J.J. Kleinsasser*, (CA-9), 83-1 USTC ¶9415, 707 F2d 1024, 1027 (a corporation cannot, for federal income tax purposes, be classified a partnership).

4 The requirement for eligibility to elect S corp status, being a Code Sec. 1361(b) "small business corporation," apply at both the level of the entity (*e.g.*, the corporation must be "domestic"; Code Sec. 1361(b)(1), Reg. §1-1361-1(b)(1)) and at the shareholder level (*e.g.*, no more than 100 shareholders; Code Sec. 1361(b)(1)(A); Reg. §1.1361-1(b)(1)(i)). *See generally* JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAX'N OF S CORPORATIONS ¶ 3.01 (4th ed.).

5 *See* Code Sec. 1361(b)(1)(D); Reg. §1.1361-1(b)(1)(iv). Differences in voting rights are permitted. Code Sec. 1361(c)(4).

6 No Form 8832 is necessary if the unincorporated entity desires its default classification; it is not necessary to affirmatively elect into that default classification.

7 Reg. §301.7701-3(c)(1)(v)(C) provides that an eligible entity desiring S corp status may file a Form 2553, which will be deemed to constitute as well an election of corporate classification as would otherwise be made on Form 8832.

8 For a general review of the charging order, see Thomas E. Rutledge, State Law & State Taxation Corner, *Charging Orders: Some of What You Ought to Know (Part I)*, J. PASSTHROUGH ENTITIES, Mar.-Apr. 2006, at 15; *Charging Orders: Some of What You Ought to Know (Part II)*, J. PASSTHROUGH ENTITIES, Jul.–Aug. 2006, at 21. See also Thomas E. Rutledge, Carter G. Bishop and Thomas Earl Geu, *Foreclosure and Dissolution Rights of a Member's Creditors: No Cause for Alarm*, 21 PROPERTY & PROBATE 35 (2007); Rutledge and Sarah Sloan Wilson, *An Examination of the Charging Order under Kentucky's LLC and Partnership Acts (Part I)*, 99 Kentucky Law Journal Online 85 (2011); (Part II), 99 Kentucky Law Journal Online 107 (2011).

9 With one exception, the charging order is uniquely a component of unincorporated business law and is absent from business corporation law. That one exception is Nevada, which has a charging order provision for certain corporations in its business corporation act. *See* Thomas E. Rutledge, State Law & State Taxation Corner, *Nevada's Corporate Charging Order: Less there than Meets the Eye*, J. PASSTHROUGH ENTITIES, Mar.–Apr. 2008, at 21.

10 *See* Thomas Earl Geu and Thomas E. Rutledge, *The Albright Decision—Why a SMLLC is not an Appropriate Protection Vehicle*, 5 BUSINESS ENTITIES 16 (2003); *see also* Thomas E. Rutledge, State Law & State Taxation Corner, *I May Be Lost But I'm Making Great Time: The Failure of Olmstead to Correctly Recognize the Sine Qua Non of the Charging Order*, J. PASSTHROUGH ENTITIES, Nov.–Dec., 2010, at 68–69 (discussing the mechanism of foreclosure as a means for addressing single-member LLCs used for abusive asset protection); Rutledge, *Kentucky Responds Not to Olmstead, But to the Problem of Asset Protection SMLLCs*, XXVIII PUBOGRAM 17 (April 2011).

11 *See, e.g.*, MOD. BUS. CORP. ACT § 8.01; KY. REV. STAT. ANN. § 271B.8-010(1).

12 *See, e.g.*, MOD. BUS. CORP. ACT § 8.40(c); KY. REV. STAT. ANN. § 271B.8-400(2).

13 *See, e.g.*, MOD. BUS. CORP. ACT § 7.01(a); KY. REV. STAT. ANN. § 271B.7-010(1).

14 *See, e.g.*, MOD. BUS. CORP. ACT § 7.05(a); KY. REV. STAT. ANN. § 271B.7-050(1).

15 *See, e.g.*, MOD. BUS. CORP. ACT § 11.04(a); KY. REV. STAT. ANN. § 271B.11.030(2).

[16] *See generally* Thomas E. Rutledge, State Law & State Taxation Corner, *Assigning Membership Interests: Consequences to the Assignor and Assignee*, J. PASSTHROUGH ENTITIES, July–Aug. 2009, at 35. *See also* CHARLES B. ELLIOTT, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS §427 (3d Ed. 1900) ("A transferee of shares acquires the rights of the transferor..."); *Witte v. Beverly Lakes Inv. Co.*, 715 SW2d 286, 294 (Mo. App. WD 1986) (noting that "free alienability is an inherent attribute of shares").

[17] *See, e.g.*, UNIF. LTD. PART. ACT §503(a)(1), 6 (pt. 1) U.L.A. 156 (2001); UNIF. PART. ACT §27, 6 (pt. 2) U.L.A. 332 (2001); REV. UNIF. LTD. LIAB. CO. ACT §502(a)(1), 6B U.L.A. 496 (2008); DEL. CODE ANN. tit. 6, §503(a)(1) (Del. RUPA) ; *id.* §18-702(a) (Del. LLC Act); KY. REV. STAT. ANN. §362.1-503(1)(a) (KyRUPA); *id.* KY. REV. STAT. ANN. §362.280(1) (KYUPA); and §275.255(1)(a) (Ky LLC Act). *See also* REV. UNIF. PART. ACT §503(b)(1), 6 (pt.1) U.L.A. 157 (2001) (transferee to receive distributions that would have otherwise gone to the transferor); UNIF. PART. ACT §27 (1), 6 (pt. 2) U.L.A. 332 (2001) (same); REV. UNIF. LTD. LIAB. CO. ACT §502(b), 6B U.L.A. 496 (2008) (same); DEL. CODE ANN. tit. 6, §503(b) (same); *id.* § 18-702(b)(2) (same); KY. REV. STAT. ANN. §362.1-503(2)(a) (same); *id.* §362.280(1) (same); and *id.* §275.255(1)(b) (same).

[18] *See, e.g.*, UNIF. PART. ACT §27(1), 6 (pt. 2) U.L.A. 332 (2001); REV. UNIF. PART. ACT §503(a)(3), 6 (pt. 1) U.L.A. 156 (2001); UNIF. LTD. LIAB. CO. ACT §502, 6B U.L.A. 602 (2008); REV. UNIF. LTD. LIAB. CO. ACT §502(a)(3), 6B U.L.A. 496 (2008); UNIF. LTD. PART. ACT §702(a)(3), 6A U.L.A. 462 (2001); DEL. CODE ANN. tit. 6, §15-503(a)(3); KY. REV. STAT. ANN. §362.280(1); *id.* § 362.1-503(1)(c); *id.* §362.2-702(1)(c); *id.* §275.255(1)(c). Exceptions to this rule include statutory trusts organized under the Uniform Statutory Trust Entity Act which, while unincorporated, as a default rule permit free transferability of beneficial interests therein and permit the transferee to fully exercise any voting rights previously enjoyed by the transferor. *See* UNIF. STATUTORY TRUST ENTITY ACT, §601(a), 6B U.L.A. (2011 Supp.) 110. Transferability may be limited in the governing instrument. *See id.* §103(e)(2), 6B U.L.A. (2011 Supp.) 73.

[19] One that is, however, incomplete. *See, e.g.*, Thomas E. Rutledge, State Law & State Taxation Corner, *In Delectus Personae and Proxies*, J. PASSTHROUGH ENTITIES, July–Aug. 2011, at 43; Thomas E. Rutledge, State Law & State Taxation Corner, *In Delectus Personae and Organic Transactions*, J. PASSTHROUGH ENTITIES, Mar.–Apr. 2012, at 55.

[20] For example, the statute alone would not preclude a transfer to one not permitted to be a shareholder under Code Sec. 1361(b).

[21] See generally Thomas E. Rutledge, *The Place (If Any) of the Special Purpose Professional Structure in Entity Rationalization*, 58 Bus. Law. 1413 (Aug. 2003).

[22] Since then, Kentucky has revised its tax code, eliminated the license tax, and imposed a tax on all limited liability entities. *See* KY. REV. STAT. ANN. §141.0401.

[23] We here assume that the entity in question has at least two (2) members; a single-member organization may not elect to be taxed under Subchapter K. Note, however, that a single-owner organization that is otherwise eligible may elect to be taxed as an S corp.

[24] For a pro-forma comparison of Subchapter C, Subchapter S and Subchapter K in the context of a professional practice and an illustration of the complexity of this analysis, *see* Thomas E. Rutledge, Stephen M. Lukinovich and Mark S. Franklin, *Organizing a Professional Practice: An After-Tax Choice-of-Entity Calculus*, 110 J. TAX'N 135 (Mar. 2009).

[25] The FICA tax has two components. Old Age, Survivors, and Disability Insurance (OASDI) is assessed at the rate of 6.2 percent on the employee and 6.2 percent on the employer, both subject to an annually adjusted cap ($106,800 for 2010). Effective January 1, 2011, the employee portion rate was reduced to 4.2 percent. The Medicare component is 1.45 percent imposed on the employer and 1.45 percent imposed on the employee, with no wage cap applicable to either.

[26] Code Sec. 1402(a)(2). *See also* Reg. §1.1402(a)-5(a).

[27] Under the self-employment tax regime, a tax of 12.4 percent is imposed on distributions, one-half of which is deductible by the member/partner. For 2011, this rate is reduced to 10.4 percent. A Medicare-equivalent tax of 2.9 percent is likewise imposed, of which one-half is deductible. Reg. §1.1401-1(b). *See generally* ROBERT R. KEATINGE AND ANN E. CONAWAY, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY §§13:32 through 13:37 (West 2008).

[28] *D.E. Watson, P.C.*, DC-IA, 2010-1 USTC ¶50,444, 714 FSupp2d 954.

[29] *See also The IRS Targets Income Tricks*, WALL ST. J., Jan. 22, 2011.

[30] *See M.W. Melvin*, 88 TC 63, Dec. 43,632 (1987).

[31] Code Sec. 1362(b)(1). An election may be made at any time during the preceding taxable year, or on or before the 15th day of the third month of the current taxable year.

[32] Code Sec. 1361(b)(1)(D). Within the "single class" of stock there may be voting and non-voting shares that, but for that distinction as to participation of management, are otherwise economically identical. Code Sec. 1361(c)(4).

[33] *See also* Reg. §1.1361(1)(l)(i).

[34] *See* EUSTICE & KUNTZ, FED. TAX'N OF S CORPS, *supra* note 4.

[35] *Accord* KY. REV. STAT. ANN. §275.310; VERMONT STAT. ANN. §3106; and VA. CODE §13.1-1049. The Indiana provision is curious, it providing that liquidating distributions be made to the members in proportion to the "returned contribution." *See* IND. CODE §23-18-9-6(3).

[36] RULLCA §110(a), 6B U.L.A. 442 (2008).