# OPERATIONAL AND TRANSITIONAL ISSUES FOR LLCS
# OR
# TAX TOPICS BUSINESS LAWYERS CAN MASTER

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**BIOGRAPHICAL INFORMATION**

## BOND & SMYSER, LLP

Bond & Smyser, LLP is a business law firm for people that own and operate their own business. We provide business structure and financing services to middle market business owners and the persons who finance middle market businesses, to help them start, grow, properly operate and, ultimately, cash out of the business. We provide personal, one on one counseling to the business owner or financier, particularly during transitions, such as growth, financings and sales. We are legal experts in business law, finance law, including equity and debt, and tax. We prepare formation documents, securities investment agreements, loan agreements and purchase and sale agreements. We are known for our high level of expertise and pragmatic and focused solutions.

## ADRIENNE RANDLE BOND - EDUCATION

Ms. Bond is a magna cum laude graduate of Rice University (B.A. 1980) and graduated Columbia University Law School (JD, 1980) as a Harlan Fiske Stone Scholar.

## PROFESSIONAL ACTIVITIES

She is a frequent author and lecturer on corporate and securities law issues, and has served as Adjunct Professor of Corporate Law at the University of Houston Law Center. Ms. Bond is a past President of the Women's Finance Exchange and has been a member of the State Bar of Texas' Corporation Law, Continuing Education and Venture Capital Committees and is a member of the Limited Liability Company, Partnership and Unincorporated Entity Committee and the Venture Capital Committee of the American Bar Association.

# TABLE OF CONTENTS

# OPERATIONAL AND TRANSITIONAL ISSUES FOR LLCS OR TAX TOPICS BUSINESS LAWYERS CAN MASTER

## 1) INTRODUCTION

Effectively representing clients in the formation, operation and termination of their LLCs requires both a good working knowledge of state law principles and federal taxation principles. Routine issues of formation, operation and dissolution all have federal income tax effects that can be mastered in their basic format by all general business lawyers. The purpose of this paper is to discuss and link the state and federal law issues that commonly arise in the one hour conference all "general" practitioners have with their clients, and to permit that generalist to more effectively deal with a tax specialist.

## 2) STATE LAW ISSUES ON FORMATION OF LLCS

The Texas Business Organizations Code ('the TBOC") and the Secretary of State of the State of Texas have made it quite easy to form an LLC. The forms on the Secretary of State's website are interactive, and take a few minutes to complete. There are only two areas that routinely cause time consuming labor. The first is the name of the entity. I am not going to go through a detailed recitation of the rules on the naming of organizations. I would simply point out that it is not an easy task, and to make sure that your client knows it may be several days before you may finally form the LLC simply because of name availability. The second is the issue of the LLC Agreement. Under the applicable provisions of the LLC spoke portion of the TBOC, an LLC generally must (that means is required to) have members.[1] An LLC that has managers may exist without members "during a reasonable period" between the date the LLC is formed and the date the first member is admitted.[2] That means to have a duly formed LLC that you must have an LLC Agreement that contractually binds one or more persons to be members. Although the statute provides that an LLC Agreement may be oral as well as written[3], a written agreement is always highly desirable. For opinion purposes, a "duly formed and validly existing LLC" requires that an LLC agreement be signed and in place prior to the execution and delivery of any contracts binding on that entity. Keep in mind that an LLC Agreement is a contract; as such it may be amended by course of conduct, and extrinsic documents such as federal tax returns may provide evidence of the members' agreement. Also, clients who balk at putting all of their agreement down in writing should be reminded of the statute of frauds.[4] Finally the authors commend to you the discussions concerning the ethical issues of multi-party representation in the formation of any entity, including an LLC

## 3) TAX ISSUES FOR LLC FORMATION

### A. General

Generally, no gain or loss is recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.[5]

### B. Exceptions to nonrecognition rule

(i) Services

See: Receipt of Partnership Interest for Services, below.

(ii) Transfers to investment companies

A transfer of property to any LLC that qualifies as an "investment company" within the meaning of the Internal Revenue Code is taxable, with gain recognized in the traditional manner, i.e. the excess of fair market value over tax basis. A transfer of property will be considered to be a transfer to an investment company if: (a) the transfer results, directly or indirectly, in diversification of the transferor's interests, and (b) the transferee is a regulated investment company, real estate investment trust, or partnership more than 80% of the value of whose assets are held for investment and are readily marketable securities or similar interests.[6] The applicable regulations provide that

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1 TBOC §101.101(a).

2 TBOC §101.101(b) A similar rule applies to an LLC during the period between the date the continued membership of the last remaining member is terminated and the date an agreement to continue the LLC described by TBOC §11.056 is executed.

3 TBOC §101.001(1)

4 For example, the Delaware statute of frauds applied to prevent the enforcement of a provision in an unsigned LLC operating agreement of a hedge fund that provided that upon leaving a founder was entitled to a multi-year earnout purportedly worth over $100 million. The relevant signed documentation provided that a departing founder was entitled only to his capital account and compensation owed upon leaving the company. *Olson v. Halvorsen*, (Del. Chan. October 22, 2008) (C.A. No. 1884-VCC). *See also Abbott v. Hurst*, 643 So. 2d 589 (Ala. 1994).

5 IRC §721(a)

6 IRC §721(b); Treas. Reg. §1.351-1(c)(1).

diversification generally occurs if two or more persons transfer nonidentical assets.[7] However, "insignificant" nonidentical assets are disregarded,[8] and a transfer of stocks and securities will not be treated as resulting in diversification if each transferor transfers a diversified portfolio of securities.[9] Thus, the exception does not necessarily require a registered investment company under the 1940 Act, and this rule may affect the formation of traditional family limited partnership structures if 80% or more of the value of the entity's assets will consist of readily marketable securities.

(iii) Disguised sales

A partner may recognize gain if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers, when viewed together, are properly characterized as a sale or exchange of property.[10] If within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.[11]

(iv) Anti-Mixing Bowl Rules

If property other than cash contributed to a partnership by a partner is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within seven years of being contributed, the contributing partner will be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss that would have been allocated to such partner taking into account the difference between the basis of the property to the partnership and its fair market value at the time of contribution (i.e., net precontribution gain).[12] Similarly, a partner who receives a distribution of property (other than money) from a partnership will recognize gain in an amount equal to the lesser of the (i) net precontribution gain related to all property contributed by such partner to the partnership, or (ii) the fair market value of property (other than money) received in the distribution minus the adjusted basis of the partner's interest in the partnership immediately prior to the distribution (reduced by money received).[13] "Net precontribution gain" is gain on property held by the partnership for less than seven years.

### C. Liabilities

With respect to the transfer of property subject to liabilities to a partnership the transfer is properly analyzed under the rules concerning distributions to partners, and the excess of liabilities over adjusted basis is a distribution, which is taxable according to the rules on distributions. A partner will recognize gain to the extent that a distribution of money (deemed or actual) exceeds the partner's basis in his or her partnership interest.[14] The fact that the sum of the amount of liabilities assumed by the partnership exceeds the total adjusted basis of the property transferred does not automatically cause the transferor partner to recognize gain. Any decrease in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner. Conversely, any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is treated as a contribution of money by that partner to the partnership. If, as a result of a single transaction, a partner incurs both an increase in the partner's share of partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership, and only the net increase is treated as a contribution of money to the partnership.[15]

### D. Basis

In general, the tax basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership is the amount of such money and the adjusted basis of such property to

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7 Treas. Reg. §1.351-1(c)(5).

8 *Id.*

9 Treas. Reg. §1.351-1(c)(6)(i). See the cited regulation for the procedure to determine if a securities portfolio is diversified.

10 IRC §707(a)(2)(B).

11 Treas. Reg. §1.707-3(c)(1).

12 IRC §704(c)(1)(B).

13 IRC §737(a)

14 IRC §731(a)(1)

15 IRC §752; Treas. Reg. §1.752-1

the contributing partner at the time of contribution.[16] In addition, a partner may increase the partner's basis in the partner's partnership interest by the partner's share of partnership liabilities.[17] The basis to the partnership of property contributed to it by a partner is generally equal to the adjusted basis of such property to the contributing partner at the time of the contribution.[18]

### E. Disregarded Entities

Although abset an election to the contrary an unincorporated domestic entity with a single owner (e.g., a single-member LLC) is not treated as a separate entity for federal tax purposes,[19] such an entity is separate and distinct from its owner for state law purposes. Single member LLCs are generally used to avoid personal liability for the debts, liabilities, and obligations of a business. To obtain the benefit of limited liability protection, it is important that the business entity be properly organized and that entity's separate existence be respected. Consequently, assets necessary for the success of or otherwise used in the business must be transferred into and held in the name of the entity. Because such an entity is disregarded for tax purposes, the transfer of assets to a disregarded entity should not be treated as a transfer for income tax purposes. Therefore, there should be no income tax consequences associated with transferring cash or property to an entity that is disregarded for tax purposes.

### F. Other

The IRS has regulatory authority, which it has not exercised, to provide that the nonrecognition rule of IRC §721(a) will not apply if the gain would be includible in the gross income of a non-United States person[20]and to provide that the rules of IRC § 367(d)(3) will apply to treat intangibles as sold if transferred by a United States person to a foreign partnership.[21]

## 4) TAXATION OF OPERATIONS

### A. Partnerships – General

Unless the taxpayer elects to have an LLC treated as a corporation, a multi-member LLC will be treated as a partnership for federal tax purposes, and a single member LLC will be disregarded for federal tax purposes.[22] If complex regulations relating to substantial economic effect are satisfied,[23] partnerships may provide by agreement for special allocations of income so that, for example, one partner, but not all, receives a preferred return.

Partnerships and LLCs that are taxed as partnerships are flow-through entities for federal income tax purposes.[24] A general partner of a partnership is subject to self-employment taxes on the amount of the partner's share of the partnership's ordinary income from a trade or business, whether or not distributed.[25] For 2010, the self-employment tax is 15.3 percent on the first $106,800 of the partner's share of such income and 2.9 percent on any amount in excess of $106,800. This raises the tax cost of phantom income and the payment of non-deductible expenses. Limited partners currently are subject to employment taxes only on guaranteed payments for services.[26] The treatment of members of LLCs for self-employment tax purposes is unclear. See discussion in Self Employment Tax, below.

Liquidation of a partnership will be tax-free unless the partnership distributes cash to a partner and the cash exceeds the partner's basis in the partner's interest in the partnership.[27] However, "cash" for this purpose includes "marketable securities," and the non-recognition rule does not apply to the extent provided in IRC § 751 (relating to distributions with respect to unrealized receivables and substantially appreciated inventory items). Several fringe benefits are not available to partners or self-employed individuals,[28] but qualified plans are now available on substantially the same basis as for corporations. Also, the deduction for health insurance costs incurred as a

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16 IRC §722

17 IRC §752

18 IRC §723

19 Except for certain employment and excise tax purposes. See text accompanying notes 48-50, *infra*.

20 IRC § 721(c)

21 IRC § 721(d)

22 Treas. Reg. §§ 301.7701-2 *et seq*

23 IRC § 704(b) and the regulations thereunder

24 IRC § 701; Treas. Reg. § 301.7701-3(b)(1)(ii).

25 IRC § 1402

26 IRC § 707(c)

27 IRC § 731(a)

28 *E.g.*, medical reimbursement plans under IRC §105 and group life insurance under IRC §79.

trade or business expense by self-employed individuals is no longer limited.[29]

### B. Partnerships—Election to be Excluded from Subchapter K of the Internal Revenue Code

Because the Internal Revenue Code determines the classification of business entities for federal tax purposes, it is possible for associations unintentionally to become subject to the complexities of the partnership tax rules. In certain circumstances, however, unincorporated organizations can affirmatively elect to be treated as co-ownerships[30] not governed by Subchapter K of the Internal Revenue Code. Section 761(a) provides that three types of unincorporated organizations may elect to be excluded from all or part of Subchapter K: (1) organizations used for investment purposes only and not for the active conduct of a trade or business; (2) organizations used for the joint production, extraction, or use of property, but not for the purposes of selling services or property produced or extracted; or (3) dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities. The members of an organization that elects out of Subchapter K must be able to adequately determine their income without the computation of partnership taxable income. In the oil patch, the standard AAPL form of Operating Agreement expressly provides that the co-owners may take the production in kind, and this is the key provision that permits the form of the Operating Agreement to be a co-ownership for tax purposes, rather than a partnership. An election under section 761(a) allows the owners to make inconsistent elections with respect to partnership property. A section 761(a) election may also be useful if a partnership is selling property and certain partners want to do a like-kind exchange under section 1031 (an interest in a partnership that has a valid section 761(a) election in effect is treated as an interest in each of the assets of the partnership) while other partners want to sell for cash. However, because electing out of Subchapter K results in a deemed dissolution of an existing partnership, caution must be exercised in making the election to ensure that the deemed dissolution does not cause the partners to recognize gain.

### C. Federal Income Tax Rules re Partnership Agreements

The Internal Revenue Code and Federal Income Tax Regulations contain definitions and rules applicable to partnership agreements. These rules also apply to the operating agreements of LLCs that are treated as partnerships for federal income tax purposes. The basic income tax definition is:

> A partnership agreement includes the original agreement and any modifications thereto agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.[31]

For purposes of the income tax rules relating to allocations of partnership income, deductions, etc. discussed in this program's materials, "partnership agreement" includes other agreements, including some that are not between all the partners, and may include agreements with persons who are related parties to a partner.[32]

## 5) LIABILITY OF OWNERS AND MEMBERS

The TBOC provides that "except as and to the extent the company agreement specifically provides otherwise, a member or manager is not liable for a debt, obligation, or liability of the limited liability

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[29] IRC § 162(l)

[30] Owning property as co-owners is one of the requirements for an unincorporated organization to elect out of Subchapter K. See Treas. Reg. §1.761-2(a)(2) and (a)(3). Consequently, the members of an LLC cannot elect out of Subchapter K. The members of al LLC are not co-owners of the LLC's property. *See* TBOC §101.106 (the interest of a member in an LLC constitutes the personal property of the member); Priv. Ltr. Rul. 200305025 (Oct. 29, 2002) (because partners of a limited partnership own an interest in the partnership, they are not co-owners of the property owned by the partnership and, therefore, cannot elect out of Subchapter K). Under a similar rationale, partners who intend to form a general partnership or LLP arguably cannot elect to be excluded from Subchapter K. *See* TBOC §152.101 (partnership property is not property of the partners). Persons who unintentionally form a partnership, however, should be able to elect out of Subchapter K, if the other requirements are satisfied.

[31] Treas. Reg. §1.761-1(c)

[32] Treas. Reg. §1.704-1(b)(2)(ii)(h)

company, including a debt, obligation or liability under a judgment, decree or order of a court."[33] Statutory provisions, however, restrict distributions from LLCs if the entity is insolvent or would be insolvent after the distribution.[34] A 2009 amendment to the TBOC clarifies that a "distribution" for this purpose does not include amounts constituting reasonable compensation for present or past services rendered or reasonable payments made in the ordinary course of business under a bona fide retirement plan or other benefits program.[35]. A member of an LLC who receives a distribution that violates the statute or the company agreement is liable to return the contribution, and the applicable statutes of limitation that apply to the transaction vary, with the maximum period being for six years under fraudulent conveyance principles. It is unclear to what extent these restrictions may be varied by a company agreement; the authors believe that, unless creditors are at least aware of any contractual restrictions at the time they extend credit, limitations on the statutory restrictions are not likely to be binding on creditors.

A member, or the member's legal representatives or successors, who does not perform an enforceable promise "to make a contribution, including a previously made contribution, or to otherwise pay cash or transfer property" must, at the request of the LLC, "pay in cash the agreed value of the contribution" as stated in the LLC agreement or the LLC's records.[36] This is an obligation that survives the death or disability of the member. What if there is no "agreed value," as, for example, in the case of many agreements to provide services in exchange for LLC interests? Could the value be determined to be stated in the LLC Agreement or in the LLC records by reference to the cash contributed for other interests?

If a member, or the member's legal representative or successor, is obligated under TBOC §101.153 to make a contribution or otherwise to pay cash or transfer property to the LLC, or to return cash or property paid or distributed to the member in violation of the TBOC or the LLC Agreement, that obligation may be released or settled only by the consent of each member of the LLC.[37]

If a putative member or manager jumps the gun and begins acting in the name of an LLC that has not yet been formed, the person so acting will be exposed to personal liability for obligations incurred in the name of the unformed LLC.[38] In Colorado, this principle of agency law is expressed in its LLC Act[39] and has been applied to create liability for persons that acquired a business in an "LLC" for a carryback note from the LLC (thus the seller believed there was an LLC and that the note was nonrecourse). However, the lawyer for the purchaser neglected to file articles of organization for the LLC until the day following the purchase. The seller's lawyer thus was able to argue that the persons who purported to be members of the LLC were not and therefore that there was personal liability.

## 6) HOW A MULTI-STATE OPERATION IS DIFFERENT

### A. All States

All states recognize LLCs. Therefore, it is possible to conduct business in this format throughout the United States.

### B. Name

A Texas LLC that qualifies to do business in another state may have to choose a different name to use in the other state, for example, because the other state does not permit the identifier "l,c.."

### C. Handling Single Member LLCs

i. Although a single member LLC generally will be disregarded for tax purposes, a single member LLC still exists for state law purposes. Therefore, if you are transferring real estate to a single member LLC, you must concern yourself with due on sale clauses, title insurance, and the like.

ii. A single member LLC should have a written LLC agreement that provides for continuity in the event of the death or disability of the member. This may be accomplished by providing for automatic admission to membership of the member's transferee. TBOC §11.056 provides that the termination of the last remaining member of an LLC is an event requiring winding up unless within 90 days the legal representative or successor of the last remaining member agrees to continue the LLC and to become a member effective as of the date of termination or to designate another person who agrees to become a member as of such date. The statute is optional with the legal representative or successor and would not apply if the single member was still alive but incompetent. Also, the operation of TBOC §11.056 in

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33 TBOC. §101.114

34 TBOC. §101.206

35 TBOC §101.206 (f)

36 TBOC. §101.153

37 TBOC. §101.154

38 RESTATEMENT THIRD, AGENCY §4.04 and *Comment c.*

39 C.R.S. § 7-80-105

situations other than the death of a member may be problematic because of TBOC §101.111(a), which provides that the assignor of an LLC interest remains a member until the assignee is admitted as a member.

iii. If a single member LLC has a cause of action, it must be brought in the name of the LLC.

## 7) TAXATION AS PARTNERSHIP OR CORPORATION—THE CHECK-THE-BOX CLASSIFICATION SYSTEM

General. The promulgation of the "check-the-box" regulations in December, 1996 by the Internal Revenue Service eliminated previously applicable complex rules for avoiding classification of a partnership or limited liability company as a corporation for tax purposes.[40] Under these regulations, with certain limited exceptions, any domestic unincorporated entity (such as an LLC) with more than one owner will be classified as a partnership for federal tax purposes, and a single owner unincorporated entity (such as an LLC) will be disregarded for federal tax purposes.[41] In addition, under these regulations, unless the taxpayer elects otherwise, any domestic unincorporated entity with more than one owner will be treated as a partnership for federal tax purposes, and any single-owner unincorporated entity will be disregarded for tax purposes. Either a multiple owner LLC or a single member LLC may elect to be treated as an association taxable as a corporation for federal tax purposes.[42] If an election is made, it cannot be changed for sixty months unless there is more than a fifty percent change in ownership.[43]

### A. Single Member LLCs

As noted, under the check-the box classification system, a single member LLC is disregarded for federal income tax purposes unless it elects otherwise. If the sole member is an individual, for example, the LLC operations will be reportable for tax purposes on the individual's personal return as if the individual were conducting the operations personally.[44] The Treasury Regulations state "except as otherwise provided in regulations or other guidance," if a single member LLC is disregarded for federal tax purposes, it "must" use its owner's tax identification number.[45] However, the IRS web site currently states that a disregarded single member LLC must obtain a tax identification number if it has employees or maintains a Keogh plan and may obtain one if required to open a bank account or for any other reason. Accordingly, a client who desires that the client's single member LLC have a separate tax identification number may now achieve that goal in all cases.

The United States Treasury Department recently adopted revised regulations under which a single member LLC is no longer be disregarded for employment tax purposes.[46] Previously, if an entity was disregarded for Federal tax purposes, Notice 99-6, 1999-1 C.B. 321, provided that employment taxes and other employment tax obligations with respect to employees performing services for the disregarded entity could be satisfied in one of two ways: (1) calculation and payment of all employment taxes and satisfaction of all other employment tax obligations with respect to employees performing services for the disregarded entity by its owner under the owner's name and employer identification number; or (2) separate calculation and payment of all employment taxes and satisfaction of all other employment tax obligations by the disregarded entity under its own name and employer identification number. Notice 99-6 stated that ultimate liability for employment taxes remains with the owner of the disregarded entity regardless of which alternative is chosen.

The new regulations eliminate disregarded entity status for purposes of federal employment taxes as well as certain excise taxes. A disregarded entity is now regarded for employment tax purposes and will be liable for employment taxes on wages paid to employees of the disregarded entity, and be responsible for satisfying other employment tax obligations (e.g., backup withholding under IRC § 3406, making timely deposits of employment taxes, filing returns, and providing wage statements to employees on Forms W-2). The owner of the disregarded entity is no longer liable for employment taxes or satisfying other employment tax obligations with respect to the employees of the disregarded entity. The disregarded

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40 Treas. Reg. §301.7701-2, et seq

41 The exceptions are a business entity that is organized under a state statute that describes or refers to the entity as a joint-stock company or joint-stock association, an insurance company, a state-chartered bank if any of its deposits are insured under the Federal Deposit Insurance Act, a business entity that is wholly owned by a state or political subdivision of a state, and a business entity that is taxable as a corporation under another provision of the Internal Revenue Code. Treas. Reg. §301.7701-2(b)

42 Treas. Reg. §301.7701-3(c)(1)

43 Treas. Reg. §301.7701-3(c)(1)(iv)

44 Treas. Reg. §301.7701-2(a)

45 Treas. Reg. §301.6109-1(h)(2)(i).

46 Treas. Reg. §§ 1.1361-4; 1.1.361-6; 301.7701-2 Fed. Reg. Vol. 70, No. 200, p. 60475

entity continues to be disregarded for other Federal tax purposes. The individual owner of a disregarded entity continues to be treated as self-employed for purposes of Self Employment Contributions Act taxes and not as an employee of the disregarded entity for employment tax purposes.[47] The new regulations were adopted, effective January 1, 2009, for wages and effective January 1, 2008, for certain excise taxes.[48]

## 8) DISTRIBUTIONS AND ALLOCATIONS

Issues arising from partnership distributions and allocations include guaranteed payments, receipt of partnership interests for services, deemed sales, special allocations of income or deduction, and allocations of debt.

### A. Guaranteed Payments

A guaranteed payment is a payment made to a partner for services or for the use of capital but only if it is payable in all events, without regard to the partnership's net income.[49] A guaranteed payment is deducted or capitalized by the partnership and should be ordinary income to the recipient partner. Note that this treatment differs from distributions made to partners in their capacity as partners.[50] Partnerships making guaranteed payments may deduct the payment to the extent that a payment to a non-partner under the same circumstances would be deductible. That is, if the payment were for services otherwise qualifying as ordinary and necessary business expenses, the payment is deductible. If a similar payment to a non-partner would have been capitalized, the guaranteed payment must be capitalized by the partnership. The partner's recognition of a guaranteed payment as ordinary income must match the timing of the partnership's corresponding deduction or capitalization.[51] This is true even where the partnership simply accrues the deduction or capital item. Conversely, the timing of deductions for payments made in a non-partner capacity must match the recipient partner's recognition of income. A partner receiving a guaranteed payment is not an employee for purposes of withholding taxes, deferred compensation plans, etc., but a guaranteed payment for services is included in the recipient's net earnings from self-employment if the services are rendered in connection with a trade or business carried on by the partnership.[52]

### B. Receipt of Partnership Interest for Services and a Discussion of Section 83(b)

[Note: The following discussion sets forth the applicable law as of April 15, 2010, the date of finalization of this paper. Proposed Regulations were published in the Federal Register for May 24, 2005, and Notice 2005—43 was published in 2005-24 I.R.B on June 13, 2005. These proposed regulations and this Notice would not substantially change the rules discussed in the following portion of this paper, but would impose new technical requirements and requirements for an election under IRC §83. If these proposed regulations are finalized before the date of the program for which this paper was prepared, information will be provided at the program.] Generally, no gain or loss is recognized to a partnership or its partners upon the contribution of property to the partnership in exchange for a partnership interest.[53] Treas. Reg. §1.721-1(b)(1) states: "[t]o the extent any of the partners gives up part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services … [IRC §] 721 does not apply." On its face, the regulation indicates by negative implication that the receipt of an interest solely in future partnership profits is not a taxable event even though the recipient has received economic value.

Courts have differed from this interpretation and imposed federal income tax on the receipt of partnership interests for services. Compare Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974) with Campbell v. Commissioner, 943 F. 2d 815 (8th Cir. 1991). Much of the early debate over the taxation of receipts of profits interests centered around the difficulty of valuing such an interest. For example, in St. John v. United States, 84-1 USTC 9158 (C.D. Ill. 1983), the court held the taxpayer was not required to report income from the receipt of a partnership interest that did not entitle the taxpayer to assets upon liquidation of the partnership until all other partners were repaid their initial capital contributions and the value of the partnership assets in the year of receipt of the interest did not exceed the value of the initial contributions by the other partners.

Rev. Proc. 93-27, 1993-2 C.B. 343, as clarified by Rev. Proc. 2001-43, 2001-34 I.R.B. 1, provides some certainty for planning purposes. Rev. Proc. 93-27

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47 *Id. See* text at notes 82-115, *infra*.

48 T.D. 9356, 72 Fed. Reg. 45,891 (August 16, 2007).

49 IRC §707(c)

50 IRC §731 (gain or loss generally not recognized on distributions to partners)

51 IRC §706(a)

52 IRC §1402

53 IRC §721(a)

declares that the receipt of a profits interest in exchange for services in a partner capacity, or in anticipation of becoming a partner, will not be treated as taxable event to either the recipient partner or the partnership. Rev. Proc. 93-27 provides that a "profits interest" is anything other than a capital interest, and a "capital interest' is "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." However, Rev. Proc. 93-27 does not apply if (a) the profits interest relates to a substantially certain and predictable stream of income from partnership assets; (b) if within two years of receipt the partner disposes of the profits interest; or (c) if the profits interest is a limited partnership interest in a publicly traded partnership.

Rev. Proc. 93-27 provides that the determination whether an interest is capital in nature is made at the time of receipt of the interest. Rev. Proc. 2001-43 provides that the determination is made at the time of the grant of the interest, regardless whether the interest is substantially vested (under IRC §83) if: (a) the partnership and service provider treat the service provider as the owner of the interest from the date of grant, and the service provider takes into account the distributive share of partnership income, gain, loss, etc. associated with that interest for purposes of computing the service provider's income tax liability; and (b) upon the grant of the interest or at the time it becomes substantially vested, neither the partnership nor any other partner deduct any amount for the fair market value of the interest.

If a partnership transfers a capital interest as compensation for services, the service provider will be taxable under IRC §83.[54] If the capital interest is not subject to a substantial risk of forfeiture at the time of grant, the service provider will immediately recognize income in the amount of the fair market value of the capital interest, reduced by the amount, if any, the service provider pays for the interest. All of this income will be ordinary compensation income, subject to wage withholding and payroll taxes if the service provider is an employee.[55] Upon receipt of the capital interest (combined with a profits interest), the service provider generally should become a partner in the partnership for both state and tax law purposes.[56] The service provider should be treated as a partner because, among other reasons, the amount that the service provider receives in respect of the service provider's partnership interest is subject to entrepreneurial risk of the partnership. If, along with the other partners, the service provider/partner is subsequently allocated a distributive share of partnership income, the character of such income will be capital or ordinary, depending on the character at the partnership level. Guaranteed payments made to the service provider/partner (i.e., those payments which are made to the service provider regardless of the income of the partnership) will still constitute ordinary compensation income.[57]

The partnership should be entitled to a deduction equal to the amount of income recognized by the service provider at the time of issuance (provided that such an expense is not required to be capitalized by the partnership). The partnership also will be entitled to deductions for any guaranteed payments made to the service provider/partner after the issuance, subject to Section 263A and other capitalization provisions.

It is uncertain whether the transfer of a capital interest will cause the partnership to recognize gain from the issuance, especially if the partnership has appreciated assets. Under general principles of taxation, the satisfaction of an obligation with appreciated property is a taxable event.[58] Therefore, the issuance of the capital interest could be viewed to involve a deemed transfer of an undivided interest in the partnership's assets to the service provider followed immediately by the recontribution of such assets to the partnership. This treatment should mark-to-market the tax basis of the assets deemed transferred to the service provider and the service provider should enjoy the benefit of the basis adjustment.[59] Generally, it would

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54 *See Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. (CCH) 1171 (1990), *aff'd*, 1969 F.2d 669 (8th Cir. 1992) (applying Section 83). *See also*, *United States v. Frazell*, 335 F.2d 487 (5th Cir. 1964) (*cert. denied*). *See also* Treas. Reg. § 1.721-1(b)(1) (providing a Section 83-like rule that capital interests provided to service partners are taxable in the year in which the interests are no longer contingent on the service partner's performance of services).

55 *See* Treas. Reg. § 1.721-1(b)(1); *See also* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships*, Warren, Gorham & Lamont, 3d edition at ¶ 5.01 (1997).

56 *See* Gary C. Karch, *Equity Compensation by Partnership Operating Businesses*, Taxes, December 1996 at 725.

57 *See* I.R.C. § 707(c)

58 *See generally*, *McKee*, *supra* note 55 at ¶ 5.08[2][b]

59 The amount of gain or loss recognized on the transfer would equal the sum of the amount, if any, paid by the service provider, the amount of the partnership's compensation deduction, and the service provider's share of

seem appropriate to "book-up" the capital accounts[60] immediately prior to the transfer of the capital interest, and to allocate the compensation or other deductions with respect to the capital interest transfer to the historical partners in accordance with the partnership agreement.

Alternatively, the partnership could be viewed as having paid to the service provider cash equivalent to the income recognized by the service provider. The service provider would then be viewed as having contributed to the partnership the cash deemed transferred to the service provider. Under this so-called "cash-out cash-in" approach no gain is recognized by the partnership upon grant of a capital interest to the service provider. It appears that the deduction attributable to the partnership's deemed compensatory payment of cash to the service provider should be allocated entirely to the historical partners in accordance with the partnership agreement. It is clearly appropriate, and generally recommended, to book-up the capital accounts under the cash-out cash-in approach.

If the capital interest is subject to a substantial risk of forfeiture, then the service provider will not be taxed upon the issuance of the interest.[61] However, the service provider may elect, under IRC §83(b), to be taxed currently on the fair market value of the issued capital interest.

If a Section 83(b) election is not made, at the time the capital interest vests in the future, the service provider will recognize income in the amount of the fair market value of the capital interest on the date of vesting (less any amount the service provider paid for the interest). The gain will be ordinary compensation income. Note that the amount of gain could be substantial due to the possible appreciation of the capital interest between the time of issuance and the time of vesting.

Under Section 1.83-1(a)(1) of the Treasury Regulations, the service provider will presumably not be recognized as a partner in the partnership for tax purposes until the service provider's capital interest vests.[62] This likely means that: (1) items of partnership income and loss should not be allocated to the service provider before vesting; and (2) any distributions made by the partnership to the service provider will constitute ordinary compensation income.

After the capital interest vests, the service provider will likely be recognized as a partner for tax purposes. Guaranteed payments made to the service provider (i.e., those payments which are made to the service provider regardless of the income of the partnership) will still constitute ordinary compensation income.[63] However, the service provider's distributive share of partnership profits and losses will be either capital or ordinary, depending on the character at the partnership level.

If a Section 83(b) election is made, the service provider will recognize gain immediately upon the issuance of the capital interest (fair market value over amount paid by the service provider). The future vesting of the capital interest will be a non-event from a tax standpoint. It appears that the filing of a Section 83(b) election causes the service provider to become a partner for tax purposes at the time of issuance, even though the capital interest will still be "substantially nonvested."[64]

If the service provider is regarded as the "owner" of the capital interest once a Section 83(b) election is made and the service provider satisfies the traditional requirements to become a partner for tax purposes, then future allocations of partnership gain or loss made to the service provider should be either capital or ordinary, depending on the character at the partnership level. Guaranteed payments made to the service provider should still constitute ordinary income.

At the time the service provider recognizes income (either at the time of vesting or at the time of issuance if a Section 83(b) election is filed), the partnership generally will be entitled to a corresponding compensation deduction. It is unclear whether the partnership will recognize gain upon a

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partnership liabilities, minus the partnership's basis in the assets deemed transferred to the service provider.

60 *See* Treas. Reg. § 1.704-1(b)(2)(iv)*(f)*

61 Note that the rules of Section 83 will apply to any interest received by a service provider, even if the service provider has paid fair market value for the interest when obtained. *Alves v. Commissioner*, 79 T.C. 864 (1982), *aff'd* 734 F.2d 478 (9th Cir. 1984). As a result, it will generally be prudent for partners who purchase interests from the partnership (i.e., receive them in exchange for a capital contribution) but who may have to resell them to the entity for a discounted price to make a Section 83(b) election.

62 *See* Treas. Reg. § 1.83-1(a)(1) ("[u]ntil [unvested] property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property received by the service performer . . . constitutes additional compensation").

63 *See* I.R.C. § 707(c)

64 *See* Treas. Reg. § 1.83-2(a) ("[i]f this election is made, the substantial vesting rules of Section 83(a) and the regulations thereunder do not apply with respect to such property . . . property with respect to which this election is made shall be includible in gross income as of the time of transfer even though such property is substantially nonvested").

deemed capital shift of partnership assets to the service provider.[65] If a Section 83(b) election is not filed, any distributions with respect to the partnership interest before the restrictions lapse should be treated as compensation paid by the partnership.[66]

After the service provider becomes a partner, any guaranteed payments made to the service provider/partner should entitle the partnership to compensation deductions subject to Section 263A or other capitalization provisions.

### C. Partnerships and Partners

A partnership is not an entity subject to tax. Its income, gains, losses, deductions, and credits are passed through according to their categories listed in IRC §702(a), and each partner reports his or her distributive share of each category on the partner's personal income tax return. Generally, a partner's distributive share of partnership income, gains, losses, deductions, and credits, is determined by the partnership agreement. If an allocation in the partnership agreement lacks "substantial economic effect," it is disregarded, and each partner's distributive share of that item is determined according to the partner's interest in the partnership.

### D. Substantial Economic Effect

The substantial economic effect test for determining the validity of a partnership allocation is a two-part test: a test for economic effect and a test for substantiality.[67] Economic effect is determined with reference to the partners' capital accounts. The regulations require for economic effect that: (a) the capital accounts must be maintained in accordance with the regulations; (b) liquidating distributions must be made in accordance with capital account balances; and (c) when liquidation occurs, partners with deficit balances in their capital accounts must restore these deficits.[68] If the partnership agreement does not require the restoration of deficit capital account balances, then the alternative test for economic effect must be satisfied. This alternative test for economic effect requires the satisfaction of (a) and (b) and that the partnership agreement contain a "qualified income offset" provision. A qualified income offset provision requires that in the event of an unexpected distribution or adjustment that results in a capital account deficit, there must be an allocation of income or gain to that partner to eliminate the deficit "as quickly as possible."[69] If the alternative test is satisfied, an allocation of loss to a partner will be treated as having economic effect if the allocation does not create a deficit capital account balance or a negative balance that exceeds the extent to which the partner is obligated to make additional future capital contributions. Also, the capital accounts must be adjusted to reflect reasonably anticipated future events (e.g., distributions) that might reduce capital accounts to deficits greater than the obligations to make future capital contributions.

The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will "affect substantially" the amounts the partners will receive from the partnership, regardless of tax consequences.[70] Even if this test is satisfied, allocations will be invalidated if they are intra-year allocations that shift tax consequences but not economic consequences or if they are "transitory allocations" that will be offset by other allocations at a later time unless, at the time the original allocations are made, there is a strong likelihood that the offsetting allocations will not occur within five years. Even if an allocation is valid under the foregoing rules, it may be invalidated by the overall-tax-effect rule. The overall-tax-effect rule invalidates an allocation scheme under which some partners are better off than they would be under a straight-up allocation scheme, and no partner is worse off than the partner would be under a straight-up allocation.

### E. Maintenance of Capital Accounts

The substantial economic effect rules require that capital accounts be maintained in accordance with rules based on tax accounting concepts rather than financial accounting principles.[71] Capital accounts must be credited with money contributed, the net fair market value of contributed property, and allocations of partnership "book" income and gains. Capital accounts must be debited with money distributed, the net fair market value of property distributed, allocations of expenditures that are non-deductible and non-capital, and allocations of partnership "book" loss and deductions. Money contributed includes the partner's assumption of partnership liabilities, and money distributed includes the partnership's assumption of the partner's liabilities.[72] Liabilities are

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65 *See* text accompanying notes 58-60, *supra*.

66 Treas. Reg. § 1.83-1(a)(1)

67 Treas. Reg. §1.704-1(b)(2)

68 Treas. Reg. §1.704-1(b)(2)(ii)(b)

69 Treas. Reg. §1.704-1(b)(ii)(d)

70 Treas. Reg. §1.704-1(b)(2)(iii)(a)

71 Treas. Reg. §1.704-1(b)(2)(iv)(a)

72 Treas. Reg. §§1.704-1(b)(2)(iv)(b)(5) and (2)

assumed for this purpose only if the assuming party is subject to personal liability, the obligee is aware of the assumption and can directly enforce the assuming party's obligations, and between the assuming party and the original obligor the assuming party is ultimately liable.[73]

IRC §707(c) guaranteed payments affect capital accounts only to the extent they affect the partners' distributive shares of loss, deduction, or other debit adjustments resulting from such payments.[74]

IRC §704(c) requires that contributed property be booked at fair market value to avoid shifting the recognition of built-in gains or losses to other partners. If the partnership sells such property, generally, the built-in gain or loss is allocated for tax purposes (not for capital account purposes) to the contributing partner.[75]

## F. Allocations Relating to Contributed Property

No gain or loss is recognized by a partnership or any of its partners if property is contributed to the partnership in exchange for an interest in the partnership.[76] Accordingly, any pre-contribution gain or loss inherent in an asset contributed to a partnership is not recognized until the contributed asset is sold by the partnership. This general nonrecognition rule does not allow the contributing partner to avoid recognizing any pre-contribution gain or loss inherent in an asset contributed to a partnership; instead, the contributing partner is allowed to defer recognizing any pre-contribution gain or loss until the partnership sells the contributed asset. Under IRC §704(c)(1)(A), income, gain, loss, and deduction with respect to property contributed to a partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property and its fair market value at the time of contribution. Section 704(c)(1)(A) specially allocates any pre-contribution gain or loss inherent in property contributed to a partnership to the contributing partner, thereby preventing such pre-contribution gain or loss from being allocated to partners other than the contributing partner. If a partner contributes appreciated property to a partnership and, within seven years of the contribution, the partnership distributes other property to the contributing partner, the contributing partner is required to recognize gain to the extent of the lesser of (a) the pre-contribution gain on property contributed by such partner to the partnership, or (b) the excess of the value of the distributed property over the partner's adjusted basis in his or her partnership interest (reduced, but not below zero, by the amount of money received in the distribution).[77] Conversely, if property contributed by a partner to a partnership is distributed to another partner within seven years of its contribution to the partnership, any pre-contribution gain or loss is recognized by the partnership and allocated to the contributing partner.[78]

## G. Allocations Relating to Nonrecourse Debt

Allocations of tax losses or deductions attributable to nonrecourse debt do not have any economic effect on the partners, but are deemed to be in accordance with the partners' interests in the partnership if they comply with the special rules in Treas. Reg. §1.704-2. The amount of nonrecourse deductions for a partnership taxable year generally equals the net increase, if any, in the amount of partnership minimum gain during that year, reduced by certain distributions attributable to nonrecourse debt. Minimum gain is the amount of gain that would be realized by the partnership if it disposed of the property subject to the nonrecourse debt in satisfaction of the debt.[79] For example, assume a partnership owns a building for which it paid $1,000,000, financed with an $800,000 interest-only nonrecourse mortgage and $200,000 cash. If the partnership claims $90,000 per year in depreciation deductions, its basis in the property at the end of year three will be $730,000. If it were to dispose of the building solely in satisfaction of the $800,000 nonrecourse mortgage, it would realize $70,000, which is its minimum gain for year three.[80]

The Treasury Regulations provide a safe harbor for the allocation of nonrecourse deductions:

a. Capital accounts must be maintained in accordance with the rules discussed above;
b. Liquidating distributions must be made in accordance with the partners' positive capital account balances;
c. A qualified-income-offset provision must be included in the partnership agreement;
d. Specially adjusted capital accounts must be determined each year pursuant to the requirements of the alternative economic effect test for purposes of limiting the items

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73 Treas. Reg. §1.704-1(b)(2)(iv)(c)

74 Treas. Reg. §1.704-1(b)(2)(iv)(o)

75 Treas. Reg. §1.704-3

76 IRC §721

77 IRC §737(a)

78 IRC §704(c)(1)(B)

79 Treas. Reg. §1.704-2(d)

80 Treas. Reg. §1.704-2(m), Example (1)(i)

of deduction or loss that may be allocated to limited partners;

e. The allocations of nonrecourse deductions must be reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities; and

f. The agreement must contain a minimum gain chargeback provision.[81]

Minimum gain chargeback comes into play if there is a net decrease in partnership minimum gain.

**9) SELF-EMPLOYMENT TAX**

Like sole proprietors, individuals are generally required to treat their distributive share of ordinary income and loss as net earnings from self-employment ("NESE") which is subject to old age, survivors, and disability tax on their distributive shares of income from a partnership.[82] There are exceptions for certain types of distributions of rent,[83] gain or loss from disposition of property,[84] and investment income.[85]

The self-employment tax consists of two components: (a) a 12.4 % tax for old-age, survivors, and disability ("OASDI"); and (b) a 2.9% tax for hospital insurance ("HI").[86] For 2010, the OASDI component of the self-employment tax applies to the first $106,800 of an individual's net earnings from self-employment, and the HI component applies to all of an individual's net earnings from self-employment.[87]

"Net earnings from self-employment" includes an individual's distributive share of income or loss from any trade or business carried on by a partnership of which the individual is a member.[88] A limited partner's distributive share of income or loss (other than guaranteed payments under IRC §707(c)) are excluded from the definition of "net earnings from self-employment."[89]

2013 will see an expansion in the reach of the self-employment tax. Pursuant to the Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act, individuals who have in excess of $250,000 of NESE (joint return filers, $125,000 for married taxpayers filing separate returns; $200,000 for other taxpayers) will owe an extra 0.9% HI tax. In addition, beginning in 2013, individuals with adjusted gross income in excess of $250,000 (joint return filers, $125,000 for married taxpayers filing separate returns; $200,000 for all other taxpayers) will owe a new 3.8% "Medicare Distribution Tax" on net investment income. Net investment income includes:

- Interest (but not tax-exempt municipal bond interest)
- Dividends
- Annuities
- Rents
- Royalties
- Capital gains
- Passive business income

This new tax applies only to an individual's adjusted gross income over the threshold amount, or, if less, the individual's net investment income.

Originally, the self-employment tax applied to a partner's distributive share of the partnership's trade or business income without regard to the character of the partner's interests in the partnership. In 1977, to stop the practice of investors purchasing limited partnership interests as a way to qualify for social security benefits, Congress amended the self-employment tax rules to exclude a limited partner's distributive share of partnership income or loss.[90] The self-employment tax rules do not consider the degree of a limited partner's activity with the partnership. If a partner is classified as a limited partner, then the partner's distributive share of income or loss is not subject to the self-employment tax (except to the extent the partner receives guaranteed payments under IRC §707(c), regardless of whether the limited partner is actively engaged in the day-to-day operations of the limited partnership.[91]

For purposes of determining net earnings from self-employment, a partnership is a business entity that is recognized as a partnership for income tax purposes. For income tax purposes, the term "partnership" includes common law partnerships, syndicates, groups,

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81 Treas. Reg. §1.704-2(e)

82 IRC §1402(a)Reg §1.1402(a)-1(b)

83 IRC §1402(a)(1); Reg §1.1402(a)-4

84 Reg §1.1402-2(a)(6)

85 IRC §1402(a)(2); Reg §1.1402(a)-5

86 IRC §1401

87 IRC §1402(b)

88 IRC §1402(a)

89 IRC §1401(a)(13)

90 House Committee Report on Pub L No. 95-216, 91 Stat 1509 (1977)

91 Thomas E. Fritz, Flowthrough Entities and the Self-Employment Tax: Is it time for a Uniform Standard?, 14 Va. Tax. Rev. 811, 830 (1998)

pools, joint ventures, or other unincorporated organizations which carry on any trade or business, financial operation, or venture and which is not a trust, estate, or corporation.[92] For federal income tax purposes, unless an election to be treated as an association taxable as a corporation is made, a limited liability company with two or more members is classified as a partnership, and a single member limited liability company is characterized as a sole proprietorship, branch, or division of the member.[93] The self-employment tax rules do not classify members of a limited liability company as general or limited partners. To address this issue, the IRS issued proposed regulations in 1994 and 1997.

The 1994 proposed regulations provided generally that a member's net earnings from self-employment included the member's distributive share of income or loss from any trade or business carried on by a limited liability company. However, the 1994 proposed regulations also provided that a member would be treated as a limited partner for self-employment tax purposes if: (a) the member was not a manager; and (b) the limited liability company could have been formed as a limited partnership under the law of the governing jurisdiction and the member would have qualified as a limited partner under that law. The 1994 proposed regulations defined a manager as a person who had authority to make management decisions necessary to conduct the limited liability company's business; if a limited liability company had no managers, each member was treated as a manager.

In 1997, in response to comments made on the 1994 proposed regulation, the IRS withdrew the 1994 proposed regulations and issued new proposed regulations. The 1997 proposed regulations apply to all entities classified as partnerships for federal tax purposes. In general, the 1997 proposed regulations provide that an individual will be treated as a limited partner unless the individual: (a) has personal liability for the debts of or claims against the partnership (the "Liability Test"); (b) has authority to contract on behalf of the partnership pursuant to the law under which the partnership is organized (the "Authority Test"); (c) participates in the partnership's trade or business for more than 500 hours during the taxable year (the "Participation Test"); or (d) provides more than a de minimus amount of services to or on behalf of an LLC, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting (the "Personal Services Test'). The 1997 proposed regulations also permit an individual to hold both a general partner interest (subject to self-employment tax) and a limited partner interest (not subject to self-employment tax) under certain circumstances.

The 1997 Regulations, while generally clear, rational, and fair, drew a firestorm of criticism from Congress and others[94] because they applied to all tax partnerships, including state law limited partnerships, and, thus, in some highly unusual circumstances, might cause an individual's interest which would be characterized as a limited partnership interest under state law not to be treated as a limited partner for purposes of determining NESE.[95] In response to this criticism, the Taxpayer Relief Act of 1997 imposed a moratorium that prevented the IRS from finalizing the 1997 proposed regulations until July 1, 1998.

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92 Treas. Reg. §1.1402(a)-2(f)

93 Treas. Reg. §301.7701-2(b)

94 See, e.g., letter from Christopher Bond to Robert Rubin, April 9, 1997; Archer, Roth Protest Limited Partnership Regs, 97 Tax Notes Today 70-41, (1997); Congressional Republicans Assail Limited Partnership Regs, 97 Tax Notes Today 70-6 (1997); Forbes Chides GOP Leaders for Waffling on Tax Cuts, 97 Tax Notes Today 69-5 (1997); Review{and}Outlook: Stealth Tax, Wall Street Journal, Monday, May 5, 1997 Section A; Page 18, Column 1.

95 A state law limited partnership interest would be treated as not being a limited partnership interest for NESE purposes only if:

(1). the individual participates for more than 500 hours during the year in the activities of the limited partnership and does not hold an interest that is identical to the interest of a person who is treated as a limited partner under the 1997 Regulations; or

(2). the individual holding the interest provides more than a de minimis amount of services to a limited partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

Thus, the circumstances in which the distributive share of income allocable to an individual's limited partnership interest would be subject to NESE are limited to cases in which all limited partners either participated in the business or also hold general partnership interests or where the limited partnership is engaged in a licensed profession or consulting and the partner is providing services. Neither of these circumstances is common, and the individuals owning limited partnership interests who will be adversely affected by the 1997 Regulations should be very few, particularly in comparison to the large number of members of LLCs who will benefit from the certainty that the regulations provide. This article does not address this controversy except to note that it imposed greater uncertainty about using the 1997 Regulations as basis for planning and compliance.

Although the moratorium expired, the IRS has taken no action to finalize or withdraw the 1997 proposed regulations.

The 1997 Regulations, unlike the 1994 Regulations, provide that although an individual is not treated as a limited partner under the rules set forth above, the individual's distributive share of income attributable to certain partnership interests may be treated as the distributive share of a limited partner. In other words, the same individual who would otherwise be treated as a general partner may hold an interest as a limited partner. The 1997 Regulations accomplish this result by comparing a partnership interest of an individual treated as a general partner with interests held by individuals who would be treated as limited partners under the tests set forth above. These rules are designed to provide for the same results as would obtain in the case of a general partner who also holds a limited partnership interest. They accomplish this goal by testing both the member and the interest owned by the member.

There are two alternative tests under which the interest of a member who might otherwise be treated as a general partner will be treated as a limited partnership interest:

a. The Two Classes of Interest Test. An individual who is not treated as a limited partner under the liability test, the authority test or the participation test, may be treated as a limited partner with respect to a second class of interest that meets certain requirements. Under the regulations, the second class of interest must be held by persons who are treated as limited partners under the tests described above.[96] A person who is not treated as a limited partner as a result of the personal services test is not eligible for the two classes of interest exception.

b. The Single Class of Interest Test. An individual who is not treated as a limited partner solely by virtue of participating for more than 500 hours in a year, may nonetheless be treated as a limited partner if that individual's rights and obligations by virtue of owning that interest are identical to the rights and interests of other partners who have substantial continuing interests in the partnership and who are treated as limited partners.[97] This provision would prevent a member of an LLC with one class of interest from being treated as a general partner simply by contributing 500 hours.

In order for the general partner to be able to take advantage of these rules, the limited partners must own a "substantial, continuing interest in a specific class of partnership interest."[98] The 1997 Regulations provide that the ownership of 20% of a particular class of interest will be considered substantial.[99] Under the 1997 Regulations, the distributive share attributable to a partnership interest of an individual who would otherwise be considered a general partner will be treated as the distributive share of a limited partner if that partnership interest is identical to the interest held by "limited partners within the meaning of paragraph (h)(2)."[100] Thus, to determine the applicability of the class of interest exceptions, one must determine who a "limited partner" is and what an "identical interest" is.

The 1997 Regulations suggest that the only partners who will be considered as "limited partners" are individuals. The interests being considered are interests held by "limited partners within the meaning of paragraph (h)(2)."[101] Proposed Regulation §1.1402-2(h)(2) refers to individuals being treated as limited partners. A rigorous reading of the regulations would suggest that the limited partners owning the substantial continuing interest must be individuals. There is no policy reason for the requirement that the "limited partners" be individuals, but planners should carefully consider whether they will be able to take advantage of the 1997 Regulations with limited partners that are entities.

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96 The Proposed Regulation provides that it applies to "Limited partners within the meaning of paragraph (h)(2)." Prop Reg §1.1402-2(h)(3). Under Prop Reg §1.1402-2(h)(2), all partners are limited partners unless they meet one of the liability test, the authority test, or the participation test. It is unclear whether a partner who fails the service test (i.e., is a service partner in a service partnership) but otherwise does not have personal liability or authority or participate for 500 hours a year would be a "limited partner within the meaning of paragraph (h)(2)." It appears that because Prop Reg §1.1402-2(h)(5) provides that "an individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section" that a service partner in a service partnership would not be treated as a limited partner.

97 Prop Reg §1.1402-2(h)(4)

98 Prop Reg §1.1402-2(h)(3)(i) and 1.1402-2(h)(4)(i)

99 Prop Reg §1.1402-2(h)(6)(iv)

100 Prop Reg §1.1402-2(h)(3)(i) and 1.1402-2(h)(4)(i)

101 Prop Reg §1.1402-2(h)(3)(i) and 1.1402-2(h)(4)(i)

The question of whether the general partner's rights and obligations with respect to a particular class of interest are identical to the rights and obligations of a limited partner also requires careful consideration. While the text of the 1997 Regulations does not explain what identical rights and obligations are, the example provides some guidance.[102]

In the example, A, B, and C form an LLC that is not a service partnership. LLC allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1x for one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25% of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of $10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under state law, C has the authority to contract on behalf of LLC.[103]

Based on the treatment of the members in the example, the following rules apply:

a. A person elected as a manager will not be treated as a limited partner as a result of the application of the authority test. In other words, unlike a general partner who has authority as a direct result of being a general partner, a manager who also happens to be a member will be treated as having authority. It is not clear whether a member who is not designated as a manager but is given some authority to act on behalf of the LLC will be treated as having authority under state law, but it is probably wise to avoid unnecessary grants of authority to members in the LLC agreement or elsewhere.[104]

b. Interests may be proportionate to capital accounts and still be identical. The example indicates that B's interest is identical to A's interest in spite of the fact that B's interest is exactly twice as large as A's interest.[105] It is not clear whether interests that had been acquired for services, but otherwise were identical to interests acquired for capital, would be treated as identical for this purpose. For example, if A contributes $100 for an interest and B receives an interest with a $100 capital account in exchange for past services (and, presumably, recognizes $100 of ordinary income on the receipt) but the interests are otherwise identical, the interests should be considered identical for purposes of the regulations. Informal discussions with government representatives have suggested that this is the correct result. In contrast, drafters may want to avoid interests that carry an obligation of future services or is subject to forfeiture out of concern that such an interest may not be identical in terms of rights and obligations.

c. Interests of two members may be identical in spite of the fact that one member is treated as a limited partner and the other is not a limited partner under the Participation Test. In this case, B's interest is treated as identical to A's even though B provides services while A does not. There is nothing in the text of the regulation which requires that B receive a guaranteed payment in order for the exception to apply, but in commenting on the payment for services the Proposed Regulation notes:

> Notwithstanding, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).
>
> The authority test may be problematic for Delaware LLCs. Under the language of the regulations, a person will not be treated as a general partner unless "the individual-- . . . has authority

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[102] Prop Reg §1.1402-2(i)

[103] Prop Reg §1.1402-2(i)(i)

[104] Prop Reg §1.1402-2(i)(i)

[105] Prop Reg §1.1402-2(i)(iii)

(under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership"[106] Under the Delaware Limited Liability Company Act – unlike the TBOC and most other statutes – the fact that an LLC has a manager does not, in and of itself eliminate the agency authority of the members. Under the Delaware statute, "Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company."[107] At the very least, in the absence of a provision in the limited liability company agreement denying members qua members agency authority all members would be treated as general partners – regardless of whether the LLC had managers. Presumably, if a provision limiting the authority of member is included in the limited liability company agreement, the members would not have authority under the law of Delaware to bind the LLC and thus would not be general partners. The answer would turn on the meaning of the phrase "under the law of the jurisdiction in which the partnership is formed."

While the underpinning of the distinction under IRC §1402(a)(13) is an attempt to distinguish between returns on capital and compensation for services, neither the statute nor the text express any requirement that the distributive share not be remuneration for services. The result should be the same even if there were no guaranteed payment for the services provided. A cautious drafter may wish to provide a guaranteed payment out of an abundance of caution to be in conformity with the regulation.

d. Interests of two members should be identical in spite of the fact that one member is treated as a limited partner and the other is not a limited partner under the Liability Test or the Authority Test. In this case, regardless of whether C's interest is treated as identical to A's, C will not be treated as a limited partner because the LLC does not have two classes of interest.[108] This result gives rise to an interesting drafting issue. What would the result be if, instead of one Unit, each of A and C bought 1 Class A Unit for $1/2x and 1 Class B Unit for $1/2x, and B purchased 2 Class A Units for $1x and 2 Class B Units for $1x. Assume further that all Class A and Class B Units were identical and all other facts are as set forth in the example. In this case, C's interest in the LLC as represented by Class A Units should be treated as the interest of a limited partner under the Two Classes of Interest Test because A, a limited partner under the 1997 Regulations, owns a continuing substantial interest in the Class A Units and the Class A Units are identical, and there are two classes of Units. Note that the same analysis should apply to the Class B Units, so that all of C's distributive share from Class A and Class B Units should be treated as net income from self-employment.

As noted above, the Two Classes of Interest Test allows a person who would not be treated as a limited partner as a result of any of the Liability Test, the Authority Test, or the Participation Test to be treated as a limited partner with respect to any interest with respect to which a limited partner owns an interest which is identical to the interest of a limited partner so long as there are two classes of interest. This test suggests that an interest will be considered identical even though the person owning the interest has individual liability and authority to bind, so long as the interests are otherwise identical. Under this analysis, it would appear that in an entity organized as a limited partnership under state law, if each of the general partners and limited partners held interests in two classes, each class of which was identical, that the general partner's distributive share with respect to each

[106] Prop. Reg. § 1.1402(h)(2)(ii)

[107] 6 Del. Code 18-402

[108] Note that the Single Class of Interest Test only applies to a partner who is not treated as a limited partner under the Participation test.

of the classes would be treated as made to a limited partner. This result is counter-intuitive in that one would assume that, in a state law limited partnership, at least some interest of the general partner would be treated as not being a limited partner interest. Again, the cautious drafter may wish to provide for an interest that is only held by the general partner and a second interest held by all partners to avoid this result.

The Report of the Joint Committee on Taxation ("JCT Report")[109] goes further than the proposed regulations suggesting that members and partners would be treated as employees with respect to all guaranteed payments for services under IRC §707(a) or deemed nonpartner payments under IRC §707(c). In addition, the distributive share of all limited partners or members of LLCs who participate in the business of the limited partnership or the LLC in excess of a certain number of hours would be treated as NESE except to the extent that such distributive share represents a return on the member or limited partner's capital account (determined by multiplying the capital account by an applicable federal rate).[110]

Section 935 of the Taxpayer Relief Act of 1997[111] provided, "No temporary or final regulation with respect to the definition of a limited partner under Section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998." Inasmuch as the 1997 Regulations have already been issued, but have not yet become effective, the effect of this provision on the proposed regulations is not clear. A sense of the Senate resolution urging the withdrawal of the 1997 Regulations was considered as part of the legislative process, but the final legislation merely provides that no regulations be issued (presumably after the effective date of Taxpayer Relief Act). This moratorium continues congressional misconceptions of the operation of limited partnerships at the expense of providing workable guidance to limited liability companies.

The impact of the 1997 Regulations on state law limited partnerships is trivial at best both because limited partnerships are largely being supplanted by limited liability companies and because the vast majority of the remaining limited partnerships would not be affected by the regulations, because all state limited partnership acts provide a limited partner does not have individual liability or the authority to bind the limited partnerships, the only limited partners who would be affected by the 1997 Regulations would be those who spend more than 500 hours in the trade or business or the limited partnership (and then only if the interest held by that limited partner is not identical to the interest of another limited partner who does not spend 500 hours in the business of the partnership) or a limited partner in a service partnership. While there may be some limited partnerships in which all limited partners participate for more than 500 hours, these would be quite exceptional.[112]

The other possible application of the 1997 Regulations, the services partner in a services partnership, will only apply in the case of limited partnerships devoted to health, law, engineering, architecture, accounting, actuarial science, or consulting. Even assuming that it is inappropriate from a policy standpoint to treat the consideration given to partners who provide significant services as self-employment income, the number of limited partners who would be subject to these rules would not be significant in comparison with the treatment of all individual members in limited liability companies as having net income from self-employment.

Regardless of how ill advised the moratorium on self-employment tax regulations is, individual members of LLCs still must determine how they will treat their distributive share of ordinary income from an LLC. As a result of the moratorium, there is not formal authority with respect to the appropriate treatment of a member's distributive share, which means that members and their advisers will have to determine how to account for ordinary income based on the sparse authority available. The only guidance in this area is in the form of private letter rulings holding that a member is a partner and "the members' distributive shares of income are not excepted from net earnings from self-employment by Section 1402(a)(13)."[113] This would suggest that all members, regardless of the level of their activities or their authority or participation in management, will be subject to self-employment tax. If this is the correct approach, individuals wishing to limit their exposure to self-employment tax would be constrained to use S corporations.

A second approach would be to assume that all members are "limited partners" and, except to the

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[109] Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues (JCS-6-97, J Comm Print 1997).

[110] JCT Report at pp 48 and 49

[111] Pub L No. 105-34, 111 Stat 788

[112] Even Congress recognizes this, the Statement of Managers with respect to the Taxpayer Relief Act describing with the "Passive Loss" provisions of §1221 states: "Limited partners generally do not materially participate in the activities of a partnership."

[113] Priv Ltr Ruls 9432018, 9452024, and 9525058

extent the payments represent guaranteed payments for services, the entire distributive share of ordinary income is excluded from net earnings from self-employment. There is no authority for this approach and several private letter rulings have suggested that, to the contrary, a member is presumed to be a general partner unless expressly made a limited partner by regulations.

A third alternative is to assume that the 1997 Regulations as proposed are close to what the final regulations for LLCs will look like, and to draft and report based on the proposed regulations. The dissension over the regulations discussed above is not that they make too many individuals limited partners, but that they take the benefits of being a limited partner away from some state law limited partners. That being the case, it seems reasonable to assume that regardless of the disagreement between Congress and the Service, the final regulations will resemble or be more generous than the 1997 Regulations. As noted above, there is no authority for this position (or for the proposition that in absence of regulations, a taxpayer may take "any reasonable position"). Under Regulation §1.6662-4(d)(3)(iii), proposed regulations are "substantial authority" for purposes of avoiding the accuracy-related penalty with respect to understatement of income tax.[114] The taxes imposed on net earnings from self-employment are not "income taxes," so the substantial authority rules do not apply to the determination of net earnings from self-employment. Nonetheless, in the absence of other authority, the proposed regulations provide some basis for a reporting position. Indeed, Lucy Clark, a national issue specialist in the IRS Examination Specialization Program, said in a monthly IRS news broadcast that, "If the taxpayer conforms to the latest set of proposed rules, we generally will not challenge what they do or don't do with regard to self-employment taxes." More recently, the January 15, 2010, issue of *Tax Notes Today* quoted Dianna Moss, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) as having stated "If you structure a transaction so that you're within the four corners of the proposed regulations, that's a reasonable position and we're not going to challenge it."[115] In any case, as in all areas in which there is uncertainty, the ultimate decision should be made by an informed client.

## 10) TAX AND STATE LAW ISSUES – DISSOLUTION, MERGER AND CONVERSION

### A. When is an LLC Dissolved? – State Law

Under the Texas Business Organizations Code, dissolutions of entities are governed by the general provisions of the TBOC, Chapter 11. The TBOC purposely does not use the word "dissolution" because of the confusion under the old statutes and related tax concepts with the words "dissolution," "termination" and winding up. Under the TBOC, the provisions are called "winding up," and "termination" and they provide that a Domestic Entity (including a limited liability company) must be wound up under the following circumstances:

i. the expiration of any period of duration specified in the domestic entity's governing documents (which would usually be the LLC Agreement);
ii. a voluntary decision to wind up the domestic entity;
iii. an event specified in the governing documents (again, the LLC Agreement) of the domestic entity requiring the winding up, dissolution, or termination of the domestic entity, other than an event specified in another subdivision of Chapter 11 of the TBOC;
iv. an event specified in sections of the TBOC other than Chapter 11 requiring the winding up or termination of the domestic entity, other than an event specified in another subdivision of Chapter 11; or
v. a decree by a court requiring the winding up, dissolution, or termination of the domestic entity, rendered under this code or other law.

The special rules for LLCs are found in Chapter 11, Section 11.056, with the related provision in Section 101.101(c). These rules require that an LLC have a member at all times, and failure to have a member will (subject to a cure mechanism) require the LLC to be terminated. Under Section 11.056, there is a ninety (90) day cure period for a memberless LLC to install a member, which is also tracked in Section 101.101(c). Additionally, there is a one-year cure period in Section 11.152(a), subject to the express procedures for the cancellation of the termination of the LLC as set forth in Section 101.552(c).

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[114] IRC §6662(d)(2)(B)

[115] Amy S. Elliott, "Taxpayers Can Rely on Limited Partner Employment Tax Regs, IRS Officials says," TNT (January 15, 2010).

**B. When is an LLC Dissolved – Federal Tax Rules on Termination.**

Under federal tax rules, however, even though an LLC does not windup and terminate or dissolve for state law purposes, if it is a partnership for federal tax purposes (i.e. not a single member LLC), its status as a partnership will terminate for federal tax purposes if—

i. No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. IRC § 708(b)(1)(A) or
ii. If within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. IRC § 708(b)(1)(B).

If an LLC that is taxed partnership terminates for federal tax purposes, the tax consequences will be as described below in "Liquidation of LLC interests", in the discussion of partnership distributions.

**C. Mergers and Conversions**

LLCs may be merged with other LLCs or other entities and converted into other entities, and other entities may be converted into LLCs. The laws establishing the requirements for mergers and conversions are set forth in Chapter 10 of the TBOC

(i) Conversions:

Under the TBOC, any domestic entity may be converted into another domestic entity of a different form.[116] A domestic entity may also be converted into any form of non code organization (that would be a "foreign entity" to us older attorneys) that will be recognized in the foreign jurisdiction under the law of which the non code organization will be considered to have been formed after the conversion.[117] A foreign entity may be converted into any form of domestic entity if the conversion is not prohibited by the foreign law governing the entity or its constituent documents.[118]

The terms and conditions of a conversion must be approved in accordance with TBOC § 10.101(c), and the provisions invoked by that general reference. Under Chapter 101.356(c), an LLC may approve a conversion by the "affirmative vote of the majority of all of the company's members," which is a per capita rule, not based on percentage interests. Obviously if you are converting into an LLC, the operative rules are found in the sections on that particular entity. The voting requirements of the TBOC may be altered by agreement among the members. TBOC §§101.052, 101.054. If you do not have applicable LLC Agreement provisions, and there is the requirement that an existing LLC Agreement be amended, be aware that TBOC Section 101.356(d) requires unanimous vote of the members (again per capita unless changed by the LLC Agreement). Finally, it is possible to make contractual agreement limiting or placing special conditions on the approval or completion of conversions in the LLC Agreement. TBOC §§101.052, 101.054.

If a Texas LLC converts into a non code organization, under §10.106(8), the resulting entity is considered to have appointed the Secretary of State of the State of Texas as its agent for service of process in a proceeding to enforce any obligation or the rights of dissenting owners or members of the converting domestic entity, and is further considered to have agreed that the converted entity will promptly pay the dissenting owners or members of the converting domestic entity the amount, if any, to which they are entitled under the TBOC.

To effect a conversion under the TBOC, the converting entity must first adopt a plan of conversion[119] with the following requirements:

a. the name of the converting entity;
b. the name of the converted entity;
c. a statement that the converting entity is continuing its existence in the organizational form of the converted entity;
d. a statement of the type of entity that the converted entity is to be and the converted entity's jurisdiction of formation;
e. the manner and basis of converting the ownership or membership interests of the converting entity into ownership or membership interests of the converted entity;
f. any certificate of formation required to be filed under this code if the converted entity is a filing entity; and
g. the certificate of formation or similar organizational document of the converted entity if the converted entity is not a filing entity.

An item required by (f) or (g) above, may be included in the plan of conversion by an attachment or exhibit to

[116] TBOC § 10.101)(a)

[117] TBOC §10.101(a) and (b) and §10.102, Conversion of Non-Code Organizations.

[118] TBOC §10.101(D)

[119] TBOC §10.103

the plan. The TBOC permits any other provisions in the plan that are not inconsistent with the "law."

(ii) Effect of Conversion

When a conversion is effective, the converting entity is converted into the resulting entity, and the resulting entity is thereafter subject to all of the provisions of the organic statutes applicable to surviving entity.[120] For example, if a Texas LLC is converted into a Texas corporation, after the conversion the resulting entity, i.e., the corporation, is subject to the corporate law provisions of the TBOC, not the LLC Act. However, the corporation is not considered a new entity.[121] Unless otherwise agreed, the conversion does affect any obligation of the converting entity incurred before the conversion or the personal liability of any person incurred before the conversion.[122] The conversion of a Texas LLC into another entity does not cause dissolution of the LLC or require that it be wound up.[123]

Under the TBOC, the effects of conversion are specifically set forth[124] as follows:

a. the converting entity continues to exist without interruption in the organizational form of the converted entity rather than in the organizational form of the converting entity;
b. all rights, title, and interests to all property owned by the converting entity continues to be owned, subject to any existing liens or other encumbrances on the property, by the converted entity in the new organizational form without:
    1) reversion or impairment;
    2) further act or deed; or
    3) any transfer or assignment having occurred;
    4) all liabilities and obligations of the converting entity continue to be liabilities and obligations of the converted entity in the new organizational form without impairment or diminution because of the conversion;
    5) the rights of creditors or other parties with respect to or against the previous owners or members of the converting entity in their capacities as owners or members in existence when the conversion takes effect continue to exist as to those liabilities and obligations and may be enforced by the creditors and obligees as if a conversion had not occurred;
    6) a proceeding pending by or against the converting entity or by or against any of the converting entity's owners or members in their capacities as owners or members may be continued by or against the converted entity in the new organizational form and by or against the previous owners or members without a need for substituting a party;
    7) the ownership or membership interests of the converting entity that are to be converted into ownership or membership interests of the converted entity as provided in the plan of conversion are converted as provided by the plan, and if the converting entity is a domestic entity, the former owners or members of the domestic entity are entitled only to the rights provided in the plan of conversion or a right of dissent and appraisal under the TBOC.

There are special provisions to deal with the issue of converting to or from a general partnership in which the partners have personal liability to or from an entity that has limited liability, that should be followed if you have a transaction[125] with a general partnership.

To complete the conversion under the TBOC, the converting entity must file with the Secretary of State of the State of Texas a Certificate of Conversion.[126] The form of certificate grants the choice between filing the required plan of conversion with the Secretary of State, or through a statement in the Certificate of Conversion that the Plan of Conversion is available and on file with at the principal office of the converted entity. A Texas entity that is converting must file (as well as any non code entity that is converting into a Texas entity) the form of Certificate of Formation of the resulting entity. The Certificate of Conversion also requires the converting entity to certify that the conversion was properly adopted in accordance with the entity's governing documents, and applicable law.

(iii) Mergers

120 TBOC §10.106(1)

121 TBOC § 10.106(1)

122 TBOC §10.106(3)

123 TBOC. §10.106(1)

124 TBOC §10.106

125 TBOC §10.106(7)

126 TBOC §10.154 and §10.10.155

Pursuant to TBOC §10.001, a Texas LLC may be merged with any domestic entity pursuant to a plan of merger adopted pursuant to TBOC §10.001, with a non code organization, or one or more non code organizations may merge with a Texas LLC, if, in the case of each non code organization, the merger is permitted by the statutes and governing documents applicable to the non code organization.[127]

The plan of merger[128] shall include the following:

a. the name of each organization that is a party to the merger;
b. the name of each organization that will survive the merger;
c. the name of each new organization that is to be created by the plan of merger;
d. a description of the organizational form of each organization that is a party to the merger or that is to be created by the plan of merger and its jurisdiction of formation;
e. the manner and basis of converting any of the ownership or membership interests of each organization that is a party to the merger into:

    1) ownership interests, membership interests, obligations, rights to purchase securities, or other securities of one or more of the surviving or new organizations;
    2) cash;
    3) other property, including ownership interests, membership interests, obligations, rights to purchase securities, or other securities of any other
    4) any combination of the items described by Paragraphs (A)-(C);

f. the certificate of formation of each new domestic filing entity to be created by the plan of merger;
g. the governing documents of each new domestic nonfiling entity to be created by the plan of merger; and
h. the governing documents of each non-code organization that:

    1) is to survive the merger or to be created by the plan of merger; and
    2) is an entity that is not:
        1. organized under the laws of any state or the United States; or
        2. required to file its certificate of formation or similar document under which the entity is organized with the appropriate governmental authority.

In the case of a merger involving a Texas LLC, the requirements for approval of the plan of merger are the same as the requirements for the approval of a conversion, both transactions being defined as "fundamental transactions."[129]

In the case of a merger involving a Texas LLC, after the plan of merger is approved in accordance with TBOC §101.356 (the voting requirements are in the spoke of the LLC rule, not the general hub), the surviving entity is required to file a Certificate of Merger[130] with the Texas Secretary of State stating:

a. the plan of merger or exchange or a statement certifying:
b. the name and organizational form of each domestic entity or non-code organization that is a party to the merger or exchange;
c. for a merger, the name and organizational form of each domestic entity or non-code organization that is to be created by the plan of merger;
d. the name of the jurisdiction in which each domestic entity or non-code organization named under Paragraph (A) or (B) is incorporated or organized;
e. for a merger, the amendments or changes to the certificate of formation of each filing entity that is a party to the merger, or if no amendments are desired to be effected by the merger, a statement to that effect;
f. for a merger, that the certificate of formation of each new filing entity to be created under the plan of merger is being filed with the certificate of merger;
g. that a signed plan of merger or exchange is on file at the principal place of business of each surviving, acquiring, or new domestic entity or non-code organization, and the address of each principal place of business; and
h. that a copy of the plan of merger or exchange will be on written request furnished without cost by each surviving, acquiring, or new

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127 TBOC §10.001(d)

128 TBOC §10.002

129 TBOC §101.356

130 TBOC §101.151

domestic entity or non-code organization to any owner or member of any domestic entity that is a party to or created by the plan of merger or exchange and, for a merger with multiple surviving domestic entities or non-code organizations, to any creditor or obligee of the parties to the merger at the time of the merger if a liability or obligation is then outstanding.

(iv) Effect of Merger
TBOC § 10.008 provides:

a. When a merger takes effect:

1) the separate existence of each domestic entity that is a party to the merger, other than a surviving or new domestic entity, ceases;
2) all rights, title, and interests to all real estate and other property owned by each organization that is a party to the merger is allocated to and vested, subject to any existing liens or other encumbrances on the property, in one or more of the surviving or new organizations as provided in the plan of merger without:

1. reversion or impairment;
2. any further act or deed; or
3. any transfer or assignment having occurred;

3) all liabilities and obligations of each organization that is a party to the merger are allocated to one or more of the surviving or new organizations in the manner provided by the plan of merger;
4) each surviving or new domestic organization to which a liability or obligation is allocated under the plan of merger is the primary obligor for the liability or obligation, and, except as otherwise provided by the plan of merger or by law or contract, no other party to the merger, other than a surviving domestic entity or non-code organization liable or otherwise obligated at the time of the merger, and no other new domestic entity or non-code organization created under the plan of merger is liable for the debt or other obligation;
5) any proceeding pending by or against any domestic entity or by or against any non-code organization that is a party to the merger may be continued as if the merger did not occur, or the surviving or new domestic entity or entities or the surviving or new non-code organization or non-code organizations to which the liability, obligation, asset, or right associated with that proceeding is allocated to and vested in under the plan of merger may be substituted in the proceeding;
6) the governing documents of each surviving domestic entity are amended to the extent provided by the plan of merger;
7) each new filing entity whose certificate of formation is included in the plan of merger under Chapter 10, on meeting any additional requirements, if any, of this code for its formation, is formed as a domestic entity under this code as provided by the plan of merger;
8) the ownership or membership interests of each organization that is a party to the merger and that are to be converted or exchanged, in whole or part, into ownership or membership interests, obligations, rights to purchase securities, or other securities of one or more of the surviving or new organizations, into cash or other property, including ownership or membership interests, obligations, rights to purchase securities, or other securities of any organization, or into any combination of these are converted and exchanged and the former owners or members who held ownership or membership interests of each domestic entity that is a party to the merger are entitled only to the rights provided by the plan of merger or, if applicable, any rights to receive the fair value for the ownership interests provided under Subchapter H; and
9) notwithstanding (d), above, the surviving or new organization named in the plan of merger as primarily obligated to pay the fair value of an ownership or membership interest under Section 10.003(2) is the primary obligor for that payment and all other surviving or new organizations are secondarily liable for that payment.

(v) Tax Consequences of Conversions Involving LLCs

**A. Conversions to LLCs from Other Entities**

The tax consequences of converting a non-LLC to an LLC will vary depending upon the form of converting entity and whether the resulting LLC is a single member or multiple member LLC.[131]

The conversion of a corporation to an LLC will be treated as follows for tax purposes:

a. A deemed liquidation of the corporation with a deemed distribution of the corporation's assets to its shareholders followed by a contribution by the shareholders of those assets to the LLC in exchange for membership interests in the LLC.[132]
b. The corporation will be taxable on the excess of the fair market value of its assets over its basis in the assets.[133]
c. A shareholder will be taxable on the excess of the fair market of the assets deemed distributed to the shareholder over the shareholder's tax basis in the shareholder's shares.[134]
d. If the corporation has a sole shareholder, the shareholder's deemed contribution of assets to the LLC will be disregarded[135] unless the LLC elects to be treated as an association taxable as a corporation. In that case, the deemed contribution should be nontaxable as a transfer to a controlled corporation.[136]
e. If there are two or more shareholders, their deemed transfer of assets to the LLC will be nontaxable as contribution to a partnership[137] unless the LLC elects to be treated as a corporation taxable as a corporation, in which case the deemed transfer should be nontaxable as a transfer to a controlled corporation.[138]
f. The LLC will retain the corporation's employer identification number.[139]

The conversion of a partnership or limited partnership to an LLC should be treated as a continuation of the partnership, unless the LLC elects to be treated as an association taxable as a corporation. In that case, the conversion should be treated as a nontaxable transfer to a controlled corporation. In Rev. Rul. 95-37,[140] the IRS has reached the following conclusions regarding the conversion of a general partnership to an LLC that will be treated as a partnership:

a. The conversion does not trigger any gain or loss to the partners or the partnership, unless there is a change in the partners' share of liabilities.[141]
b. The partners' basis in the LLC equals the partners' basis in the partnership unless there is a change in the partners' share of liabilities.
c. The LLC's tax basis in its assets is the same as the tax basis of those assets to the general partnership.
d. There is no termination for tax purposes of the partnership upon the conversion into the LLC.

The federal income tax consequences of the conversion of a limited partnership to an LLC should be the same, with the exception of possible differences based on changes in debt of the limited partnership.[142]

The foregoing tax consequences may be different if the converting entity is a foreign entity[143] or, in the

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131 James A. Fellows and Michael A. Yuhas, "Converting to a Limited Liability Company: The Issue of Debt Allocation to the LLC Members," 79 *Taxes* 23 (October 2001).

132 Treas. Reg. §§301.7701-3(g)(1)(ii), 301.7701-3(g)(1)(iv)

133 IRC §336(a)(1)

134 IRC §331(a)

135 Treas. Reg. §301.7701-2(a)

136 IRC §351

137 IRC §721(a)

138 IRC §351

139 Treas. Reg. §301.6109-1(h)(1). However, if the LLC is a single-member LLC that is disregarded for federal tax purposes, see text accompanying note 47, *supra*.

140 Rev. Rul. 95-37, 1995-1 CB 130, amplifying Rev. Rul. 84-52, 1984-1 CB 157

141 The conversion of a general partnership to an LLC could trigger "at-risk" recapture income under IRC §465. IRC §465 provides that a partner may only deduct partnership losses to the extent the partner is "at-risk" with respect to any money and the adjusted basis of any property contributed to the partnership. A partner's "at-risk" amount is reduced by any distributions from the partnership to the partner.

142 Fellows and Yuhas, *supra* note 131 at 33, 47

143 IRC §367

case of a partnership or limited partnership that converts to an LLC that elects to be treated as an association taxable as a corporation, the converting entity has liabilities that exceed the partners' basis in the assets deemed transferred to a controlled corporation.[144]

**B. Conversions of LLCs to Other Entities**

a. Conversion to a Corporation

If an LLC converts to a corporation, it will be treated for federal income tax purposes as a transfer of all the assets of the LLC to the corporation in exchange for the stock of the corporation, followed by liquidation of the LLC and distribution of the stock to its members. Rev. Rul. 2004-59, 2004-1 C.B. 1050. Ordinarily, this transaction will be tax free under section 351 of the Internal Revenue Code. Rev. Rul. 84-111, 1984 -2 C.B. 88, Situation 1. Section 351(a) provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control… of the corporation." Certain of the key provisions under section 351(a) are that the transfer must be "solely in exchange for stock" and immediately after the transfer the transferors must be in "control" of the corporation. If a transferor receives other property or money in addition to stock in the exchange, then gain (but not loss) is recognized to the extent of the amount of money and the fair market value of the other property received.[145] For purposes of section 351, "control" is defined as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.[146] In comparison to the partnership rule under section 721,[147] the "control" requirement of section 351 can make it more difficult to transfer appreciated property to a corporation without recognizing gain, especially after the initial formation and capitalization of the corporation.

**C. Exceptions to Nonrecognition Rule**

(i) Services

Stock issued for services does not qualify for nonrecognition under section 351.[148] A person who receives stock in exchange for services must include in gross income an amount equal to the excess of the fair market value of the stock (as of the time that the person's interest in the stock is transferable or not subject to a substantial risk of forfeiture[149]), over the amount (if any) paid for the stock.[150] The corporation is entitled to a deduction in the same taxable year in which the recipient recognizes income from the transaction.[151] As discussed above under Receipt of Partnership Interest for Services, it is possible to structure the issuance of a partnership interest for services without the recognition of income or gain by the partnership or the service partner.

(ii) Investment Companies

The general nonrecognition rule of section 351 does not apply in the case of a transfer of property to an investment company.[152] A transfer of property will be considered to be a transfer to an investment company if: (i) the transfer results, directly or indirectly, in diversification of the transferor's interests, and (ii) the transferee is a regulated investment company, real estate investment trust, or corporation more than 80% of the value of whose assets are held for investment and are readily marketable securities or similar interests.[153]

(iii) Liabilities

In the case of an exchange under section 351, if the sum of the liabilities assumed by the corporation exceeds the total adjusted basis of the property transferred in such exchange, then such excess is considered as gain from the sale or exchange of a capital asset or property which is not a capital asset, as the case may be.[154]

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144 IRC §357

145 IRC §351(b)

146 IRC §§351(a), 368(c)

147 See text accompanying notes 5-21, *supra*.

148 IRC §351(d)

149 Unless the service recipient elects under IRC §83(b) to include the value of the property in income when received.

150 IRC §83(a)

151 IRC §83(h)

152 IRC §351(e)(1)

153 IRC §721(b); Treas. Reg. §1.351-1(c)(1). See text accompanying notes 7-10, *supra*.

154 IRC §357(c)(1)

### D. Incorporation in Anticipation of Merger, etc.

Assume that a public company has expressed interest in acquiring your clients' LLC, and said it can pay more if it uses its stock instead of cash. The LLC's tax accountant recommends that they work toward a tax-deferred, stock-for-stock swap with the public company that has expressed an interest in acquiring their partnership by first completing a 351 tax-free incorporation of the LLC. In considering this recommendation to incorporate, the accountant examines the LLC's pre-incorporation tax-basis balance sheet to test for the existence of either excess liabilities or liabilities unrelated to the business. To the extent that liabilities transferred to the corporation exceed the bases of the assets transferred, gain recognition will occur.

In addition, to the extent any liabilities unrelated to the LLC's business are transferred to the corporation, all liabilities conveyed will be considered to give rise to taxable boot to the incorporators.

To avoid the possibility of double taxation, the tax accountant recommends an S election. As the negotiations for the sale of the business proceed, the company will operate as an S corporation. If the negotiations fail, the conversion from LLC to S status will not have significantly changed the income tax structure of the business. Conversely, if S status were not initially elected and the acquisition failed, the owners would be trapped into potential double taxation on any future sale, because the prior C status would cause the corporation to be subject to the 1374 built-in gains tax.

When the purchase agreement is finalized, the tax accountant recommends that it be structured as a B reorganization (a stock-for-stock exchange). In a B reorganization, one corporation, solely in exchange for its voting stock, acquires the stock of another corporation and immediately thereafter has control of the acquired corporation. No boot can be paid to the owners; they must receive only stock of the acquiring company. Unlike an A or C reorganization, in a B reorganization, the acquired corporation is not liquidated. The S status of the acquired corporation terminates as of the date of the stock exchange, as an S corporation cannot retain its eligibility when it has a corporate shareholder. This causes the filing of a short-period S return and pass-through of income or loss to the owners as of the termination. If properly structured and carefully executed, the stock exchange may not be taxable to the owners until they eventually sell the acquiring corporation's publicly traded stock. Their adjusted tax basis in the former LLC carries over to their newly formed corporate stock, and then to the publicly traded stock received in the stock-for-stock exchange. Each owner now has the flexibility to sell shares of stock of the publicly traded company.

In addition, if the publicly traded stock produces sufficient retirement income via its dividends, an owner might consider holding the shares through their eventual estates. If the rules allowing a step-up in basis of assets acquired from a decedent become law again, this would accomplish a basis step-up under Sec. 1014 and allow their estates or heirs to sell the stock without gain recognition. The overriding benefit is the owners may succeed in deferring income taxation by structuring a B reorganization. There are, however, potential detriments to be considered. When an S corporation is acquired in a B reorganization, the decrease in the proportionate stock ownership of the former S corporation's shareholders could cause business credit recapture. Another potential detriment is the loss of Sec. 1244 ordinary loss treatment in the event the stock is subsequently sold at a loss or becomes worthless; ordinary loss treatment is not available to a member to whom the stock is distributed by the LLC. This problem can be overcome if the incorporation of the LLC is structured so that the members (and not the LLC) are the incorporators.

If the members of an LLC agree to enter into a stock exchange with another corporation after incorporating the LLC, the IRS may seek to treat the transaction as a taxable exchange of the acquirer's stock for LLC interests by invoking the step transaction or substance over form doctrines to assert that the LLC members did not actually acquire control of the corporation formed by incorporating the LLC. S. Klien on the Square, Inc. v. Commissioner, 188 F.2d 127 (2d Cir.), cert. denied, 342 U.S. 824 (1951); Hazeltine Corp. v. Commissioner, 89 F. 2d 513 (3d Cir. 1937); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976); Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Rul. 79-70, 1979-1 C.B. 144; Rev. Rul. 70-522, 1970-2 C.B. 81. Also see, e.g., Abegg v CIR, 429 F2d 1209; King Enterprises, Inc. v. CIR, 418 F2d 511 (Ct. Cl. 1969); McDonald's Restaurants of Illinois, Inc. v. CIR, 688 F2d 520 (7th Cir.1982); Rev. Rul. 2001-26, 2001-1 C.B. 1297 (all applying step transaction principles to a series of events taking place over several months). The regulations under § 368 take seriously the business-purpose requirement. Reg. § 1.368-1(b) states that the reorganization provisions are concerned with "readjustments of corporate structures…required by business exigencies," and Regulations § 1.368-1(c) states that a scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of a tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for

concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization. See also Reg. § 1.368-2(g), which states that the transactions must be "undertaken for reasons germane to the continuance of the business of a corporation," and that the statute "contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms."

To make this work, the incorporation must be done before an agreement is reached about the sale, and the corporation's existence should be at least somewhat "old and cold." In Weikel v. Commissioner, 51 T.C.M. 432 (1986), the Tax Court held that the taxpayer had a substantial business purpose for the formation of Dispersalloy, Inc. and the transfer of his patent to it in September 1973 even though in January 1974 the taxpayer and Johnson & Johnson executed an Agreement and Plan of Reorganization pursuant to which taxpayer transferred all of his stock in Dispersalloy, Inc. to Johnson & Johnson in exchange for Johnson & Johnson stock. Although the taxpayer was in negotiations with Johnson & Johnson at the time he incorporated Dispersalloy, he was also talking to other potential acquirers and had been advised by his attorney that he should incorporate whether or not he did a deal with Johnson & Johnson because (i) it was clear that any acquirer would want to structure an acquisition of taxpayer's business so that it could be treated as a pooling of interests and (ii) it made sense to incorporate because taxpayer's business was beginning to generate profits.

The IRS relied on West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966) and Rev. Rul. 70-140, 1970-1 C.B. 73. The court in Weikel distinguished West Coast Marketing on the grounds that the taxpayer in West Coast Marketing transferred real estate to a new corporation solely to facilitate a transfer to an unrelated corporation, that all of the detail of the transfer to the acquiring corporation had been agreed on, and that the taxpayer's corporation was liquidated soon after the acquisition. Likewise, the court distinguished Rev. Rul. 70-140 on the basis that the taxpayer in the ruling had already agreed to transfer the stock of the new corporation before the taxpayer incorporated it and transferred property to it.

Weikel illustrates the importance of (i) establishing a business purpose for the incorporation of the LLC apart from the potential acquisition and (ii) incorporating the LLC before there is a binding agreement to dispose of the shares received by the members. Interestingly, in a case arising out of the same transaction that was held in abeyance pending the decision in Weikel, Johnson & Johnson argued that its acquisition of Dispersalloy should be treated as a taxable purchase. Johnson & Johnson wanted a cost basis.

### E. Conversion to Corporation—Revenue Rulings 84-111 and 2004-59

There are three possible ways in which an LLC be changed into a corporation without following the statutory conversion route. The LLC might contribute its assets to a corporation in exchange for its stock and then liquidate, distributing the stock to its members (this is commonly called an "assets over" form of incorporation). Alternatively, the LLC might liquidate, distributing its assets to its members, who then contribute those assets to a new corporation in exchange for its stock (this is commonly referred to as an "assets up" form of incorporation). The third way is for the members of the LLC to transfer their membership interests to a new corporation in exchange for its stock (this is referred to the "interests over" form of incorporation. In Rev. Rul. 84-111, 1984-2 C.B. 88, the Internal Revenue Service announced that it would respect all three forms. See also Treas. Reg § 1.708-1(b)(4). In Rev. Rul. 2004-59, 2004-1 C.B. 1050, however, the Service decided that state law conversions do not have an actual form, because the assets and interests are not actually transferred. The Service decided that such a state law conversion would be treated as if it were an asset over transaction. In most situations, taxpayers will not mind assets over treatment. However, in certain circumstances, as when the taxpayers want to be able to claim section 1244 classification for the corporate stock, one of the other classifications will be more favorable. Stock that is distributed to a partner by a partnership is not eligible for section 1244 ordinary loss treatment. Treas. Reg. § 1.1244(a)-1(b)(2), -1(c) Example (2). In such a case, the taxpayers should undertake an actual assets up or interests over transaction instead of a statutory conversion.

### F. Conversion to Another Form of Unincorporated Entity

The conversion of an LLC that is taxed as a partnership to a partnership or limited partnership should be treated as a continuation of the LLC's partnership status unless the resulting entity elects to be treated as an association taxable as a corporation. In that case, the conversion should be treated as a nontaxable transfer to a controlled corporation. In Rev. Rul. 95-37,[155] the IRS has reached the following

[155] Rev. Rul. 95-37, 1995-1 CB 130, amplifying Rev. Rul. 84-52, 1984-1 CB 157.

conclusions regarding the conversion of a general partnership to an LLC that will be treated as a partnership:

a. The conversion does not trigger any gain or loss to the partners or the partnership, unless there is a change in the partners' share of liabilities.[156]
b. The partners' basis in the LLC equals the partners' basis in the partnership unless there is a change in the partners' share of liabilities.
c. The LLC's tax basis in its assets is the same as the tax basis of those assets to the general partnership.
d. There is no termination for tax purposes of the partnership upon the conversion into the LLC.

The federal income tax consequences of the conversion of a limited partnership to an LLC should be the same, with the exception of possible differences based on changes in debt of the limited partnership.[157]

The foregoing tax consequences may be different if the converting entity is a foreign entity[158] or, in the case of a partnership or limited partnership that converts to an LLC that elects to be treated as an association taxable as a corporation, the converting entity has liabilities that exceed the partners' basis in the assets deemed transferred to a controlled corporation.[159]

## G. Federal Income Tax and Other Techniques Involved in the use of Disregarded Entities (Single Member LLCs)

As noted, under the check-the box classification system, a single member LLC is disregarded for federal income tax purposes unless it elects otherwise. If the sole member is an individual, for example, the LLC operations will be reportable for tax purposes on the individual's personal return, as if the individual were conducting the operations personally.[160] The Treasury Regulations state "except as otherwise provided in regulations or other guidance," if a single member LLC is disregarded for federal tax purposes, it "must" use its owner's tax identification number.[161] However, the IRS web site currently states that a disregarded single member LLC must obtain a tax identification number if it has employees or maintains a Keogh plan and may obtain one if required to open a bank account or for any other reason. Accordingly, any client who desires that the client's single-member LLC have its own tax identification number may obtain one. Because disregarded entities are ignored for federal tax purposes, but not state law purposes, disregarded entities offer planning opportunities that other business entities cannot completely emulate.

a. Limited Liability

If a disregarded entity is formed under a state statute like the TBOC that gives the owner limited liability protection, the owner will not be personally liable for the debts, obligations, or liabilities of the entity.

b. Rights of First Refusal

In some situations, an asset may be subject to a right of first refusal or other transfer restrictions. Depending upon the terms of the instrument containing the transfer restrictions, holding the asset in a disregarded entity may allow for transfer of ownership of the entity without triggering the transfer restrictions on the underlying asset.

c. Avoiding Tax Complexity

Because a disregarded entity is treated as a sole proprietorship, branch, or division of the owner, a disregarded entity does not file a separate tax return. The owner of a disregarded entity includes the entity's income, gains, losses, deductions, and credits directly on the owner's income tax return. A disregarded entity is not required to comply with the complex partnership rules contained in the Internal Revenue Code.

d. Transfer Taxes

The sale of tangible personal property is generally subject to sales or use tax. Depending upon the relevant state statutes, the sale of an interest in a disregarded entity that owns tangible personal property may not be subject to sales or use tax if the transaction is treated as the sale of intangible personal property.

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[156] The conversion of a general partnership to an LLC could trigger "at-risk" recapture income under IRC §465. IRC §465 provides that a partner may only deduct partnership losses to the extent the partner is "at-risk" with respect to any money and the adjusted basis of any property contributed to the partnership. A partner's "at-risk" amount is reduced by any distributions from the partnership to the partner.

[157] Fellows and Yuhas, *supra* note 131 at 33, 47

[158] IRC §367

[159] IRC §357

[160] Treas. Reg. §301.7701-2(a)

[161] Treas. Reg. §301.6109-1(h)(2)(i)

e. Like-Kind Exchanges

Under section 1031 of the Internal Revenue Code a taxpayer does not recognize gain or loss when property held for productive use in a trade or business or for investment is exchanged solely for like-kind property that is also held for productive use in a trade or business or for investment. Section 1031 does not apply to stock, securities, or partnership interests. The owner of a disregarded entity, however, is treated as directly owning the entity's underlying assets. Thus, a disregarded entity may be used to facilitate a like-kind exchange in situations in which the owner does not want to take title directly in the owner's own name.

## H. Liquidation of LLC Interests

b. General Rules Regarding Partnership Distributions. In the case of a distribution by a partnership to a partner: (1) gain is not recognized by the distributee-partner, except to the extent that the sum of any money plus the value of any marketable securities distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution; and (2) loss is not recognized by the distributee-partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than money or unrealized receivables is distributed to such partner, loss is recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of the money and unrealized receivables distributed to such partner.[162] A partnership does not recognize gain or loss on a distribution of property (including money) to a partner.[163]

This paragraph applied before the repeal of the estate tax effective for the estates of decedents dying on or after January 1, 2010. It will apply again under current law effective for the estates of decedents dying on or after January 1, 2011. When an individual dies, the decedent's successors acquire a basis in the decedent's assets equal to the assets' fair market value at the time of death (or six months later, if the alternate valuation date is elected).[164] Because a decedent's assets pass to the decedent's successors with this stepped-up basis, any unrealized appreciation at the time of death is transferred free of the income tax. In the case of a partnership interest, unless the partnership adjusts the basis of its assets in connection with the step-up in basis of the decedent's partnership interest, the decedent's successors will not realize the benefit of the step-up in basis when the partnership later sells its assets. To avoid this result and put the decedent's successors in the same position they would have been in if they had acquired a pro rata share of the partnership's assets, the partnership may make a section 754 election to adjust the basis (under section 743) of its assets upon the death of a partner.

c. Taxation on Sale of an Interest—Holding Period and Hot Asset Issues; Reporting Requirement

Gain or loss recognized on the sale or exchange of an interest unit held for more than one year generally will be taxed as a long-term capital gain or loss. A portion of this gain or loss, however, will be separately computed and taxed as ordinary income or loss under IRC §751 to the extent attributable to depreciation recapture or other "unrealized receivables" or "substantially appreciated inventory" owned by the entity.[165] "Unrealized receivables" is defined broadly to include gain recharacterized as ordinary income under the recapture rules.[166] The purchaser of a partnership interest takes a cost basis in the interest acquired.[167] Unless the partnership adjusts the basis of its assets by the amount of gain or loss recognized by the selling partner, the purchaser will essentially recognize the same gain or loss as the selling partner when the partnership later sells its assets. In order to avoid this result and put the purchaser in the same position that he or she would have been in if they had purchased a pro rata share of the partnership's assets, the partnership may make an election under IRC §754 to adjust the basis (as provided in IRC §743) of its assets.

If a partnership has a section 754 election, in effect, the sale of an interest in the partnership results in (i) an increase in the adjusted basis of the partnership's assets in an amount equal to the excess of the transferee-partner's basis in his or her partnership interest over the transferee's proportionate share of the adjusted basis of the partnership's assets, or (ii) a decrease in the adjusted basis of the partnership's assets in an amount equal to the excess of the transferee-partner's proportionate share of the adjusted basis of the partnership's assets over the transferee's basis in his or her partnership interest.[168] By making a section 754 election the transferee-partner's cost basis in his or her partnership interest is effectively transferred to the transferee's pro rata share of the

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[162] IRC §731(a)

[163] IRC §731(b)

[164] IRC §1014(a)

[165] IRC §§741, 754

[166] IRC §751(c)

[167] IRC §§742, 1012

[168] IRC §743

partnership's assets. Any increase or decrease under section 743 constitutes an adjustment to the basis of the partnership's assets with respect to the transferee-partner only. An election under section 754 is irrevocable. The redemption of a partner's interest in a partnership will be treated in the manner discussed above regarding partnership distributions.

In the case of a business entity classified as a partnership with two partners, the sale of one partner's interest to the other partner or the sale of both partners' interests to a third person will convert the partnership into a disregarded entity for federal income tax purposes. In either situation, the selling partner or partners recognize gain or loss in accordance with IRC §741. With respect to the purchaser, the partnership is deemed to have made a liquidating distribution of its assets, followed by a sale of assets by the selling partner or partners to the purchaser. If the purchaser is one of the partners, the purchasing partner will recognize gain or loss on the deemed distribution in accordance with IRC §731. The purchaser will obtain a cost basis in the assets deemed purchased in the transaction.[169]

If a partner contributes property other than cash to a partnership in exchange for a partnership interest, the partner's holding period for the partnership interest will include the period the partner held the property exchanged, if the property exchanged was a capital asset in the hands of the partner or property described in IRC § 1231 (relating to depreciable property used in a trade or business).[170]

The IRS requires a taxpayer who sells or exchanges a partnership interest to notify the LLP or LLC in writing within 30 days or, for transfers occurring on or after December 16 of any year, by January 15 of the following year. The IRS reporting requirement is limited to "Section 751(a) exchanges," which is the sale or exchange of a member's interest in the entity, part or all of such interest being attributable to (1) unrecognized receivables of the entity or (2) inventory items of the entity. The written notice required by the IRS must include the names and addresses of both parties to the transfer, the identifying numbers of the transferor and, if known, of the transferee and the transfer date. Currently the IRS imposes a penalty of $50 for failure to file the written notice unless reasonable cause can be shown. In addition, a taxpayer who sells a partnership interest will be required to attach a statement to the taxpayer's federal income tax return setting forth separately (1) the date of the sale; (2) the amount of any gain or loss attributable to unrealized receivables or inventory items; and (3) the amount of any gain or loss attributable to capital gain or loss on the sale.

### d. Using Elections to Make Optional Basis Adjustments to Minimize Tax in Distributions

A partnership does not recognize gain or loss when it distributes an asset which has appreciated or declined in value.[171] As noted above, however, a partner may recognize gain or loss in connection with a distribution or such partner may take a basis in a distributed asset that differs from the partnership's basis in such asset. To eliminate any inherent gain or loss from the partnership's remaining assets that was reported by or passed on to the distributee-partner as a result of the distribution, a partnership may make an election under IRC §754 to adjust its basis (as provided in IRC §734) in any retained assets. Under IRC §734(b), a partnership may make the following special basis adjustments to any retained assets in connection with a distribution:

1) If a partner reports gain upon the receipt of money in excess of the adjusted basis of such partner's interest in the partnership, the partnership increases the basis of its capital assets by the amount of gain reported by the distributee-partner.[172]
2) If a partner reports a loss upon the receipt if a liquidating distribution of money which is less than the adjusted basis of such partner's interest in the partnership, the partnership reduces the basis of its capital assets by the amount of loss reported by the distributee-partner.[173]
3) If a partner's basis in a distributed asset is less than the partnership's basis in the same asset, the partnership increases the basis of its remaining assets by the decrease in basis of the distributed asset.[174]

Liquidation of a partnership will be tax-free unless the partnership distributes cash to a partner and the cash exceeds the partner's basis in the partner's interest in the partnership.[175] Stated in the converse, a partner will pay tax on any cash the partner received in excess of that partner's tax basis in the partnership. "Cash" for this purpose includes "marketable securities," and the non-recognition rule does not apply to the extent provided in IRC § 751 (relating to distributions with

169 Rev. Rul. 99-6, 1999-1 C.B. 432
170 IRC §§ 722, 1223(1)
171 IRC §731(b)
172 IRC §734(b)(1)(A)
173 IRC §734(b)(2)(A)
174 IRC §734(b)(1)(B)
175 IRC § 731(a)

respect to unrealized receivables and substantially appreciated inventory items). In the case of a liquidating distribution, the distributee partner will realize ordinary income to the extent the gain in the distribution results from a disproportionate distribution of section 751 items that has the effect of the distributee partner exchanging a portion of the distributee partner's interest in section 751 assets for non-section 751 assets.

## 11) CONCLUSIONS

After almost fifty pages of tax talk for business lawyers, I would simply remind you, in conclusion, that these tax topics are important business decisions for our clients and we owe it to them to master these tax concepts.

Good Luck!