TAX ISSUES

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CHAPTER 3

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Mr. Sparkman practices law in Denver and Houston as a partner of Sparkman + Foote LLP. Mr. Sparkman's practice includes the areas of business transactions, securities, tax, and professional responsibility. Mr. Sparkman's work includes the preparation of securities disclosure documents for start-up companies in a variety of fields, including offshore oil and gas exploration, foreign mining operations, real estate, and comic book certification. Mr. Sparkman also regularly prepares LLC and partnership documents, and represents buyers and sellers of businesses, including preparing or reviewing all necessary legal documents.

Mr. Sparkman received his A. B. degree in 1968 from Princeton University and his J. D. degree with high honors from the University of Texas School of Law. In 2015, Mr. Sparkman received a Certificate in Theology and Ministry from Princeton Theological Seminary. Mr. Sparkman is listed in THE BEST LAWYERS IN AMERICA® for both Colorado and Texas and speaks regularly at continuing legal education seminars in Colorado, Texas, and nationally on entity selection, fiduciary duties and governance, mergers and conversion, veil piercing, ethics, series LLCs, and tax planning. Mr. Sparkman has presented more than 100 papers at continuing education programs for the American Bar Association, the Colorado Bar Association, Continuing Legal Education in Colorado, the State Bar of Texas, the University of Texas School of Law, the Professional Education Broadcast Network, the Practicing Law Institute, the National Business Institute, and other continuing education providers.

With Herrick Lidstone, Mr. Sparkman is author of Using Limited Liability Companies in Colorado (CLE in Colorado, Inc. 2015 second edition January, 2017) This book won the 2016 Award for Outstanding Achievement from the Association for Continuing Legal Education. He is the author of numerous articles on choice of business entity, series LLCs, and other legal topics. Mr. Sparkman's published articles include "Charging Orders—A Reconsideration," available at http://ssrn.com/abstract=2727973; "Will Your Veil Be Pierced? How Strong is Your Entity's Liability Shield?—Piercing the Veil, Alter Ego, and Other Bases for Holding an Owner Liable for Debts of an Entity," 12 *Hastings B. L. J.* 349 (2015-2016) available at http://ssrn.com/abstract=267620; with Herrick K. Lidstone, Jr., "Pick Your Partner Versus the United States Bankruptcy Code", 46 Texas Journal of Business Law, No. 2 at 23 (Fall 2015), available at http://ssrn.com/abstract=2866418; "Through the Looking Glass: Series LLCs in 2015,"3 Bus. & Bankr. L.J. 1 (2016), available at http://ssrn.com/abstract=2591548; "Series LLCs", 53 *The REPTL Reporter* No. 2 (Real Estate, Probate and Trust Law Section, State Bar of Texas, February, 2015); "The Rescission Doctrine: Everything Old is New Again," 4 AM. U. BUS. L. REV. 183 (2015), available at http://ssrn.com/abstract=251294; "Fifth Circuit Misses Opportunity to Bring Clarity to Series LLC Questions", *Business Law Today* (April 2014); "Series LLCs in Interstate Commerce" and "Tax Aspects of Series LLCs," *Business Law Today* (February 2013); and "The Series LCC: A New Planning Tool" by Adrienne Randle Bond and Allen Sparkman, 45 *Texas Journal of Business Law* (Fall 2012). Mr. Sparkman is a contributing author to Practitioner's Guide to Colorado Business Organizations (Colorado Bar Association, Allen E. F. Rozansky and E. Lee Reichert, Managing Editors), and Guide for Colorado Nonprofit Organizations (Colorado Bar Association, Karen E. Leaffer, Managing Editor).

Mr. Sparkman has served several times as an expert witness in Colorado, Texas, and California in cases involving duties of directors, director deadlock, duties of managers, duties of partners, construction of operating agreements, construction of partnership agreements, construction of contracts, veil piercing, and attorney malpractice. Mr. Sparkman has been qualified as an expert witness in the district court for Denver, Colorado.

Mr. Sparkman is a member of the American, Colorado, and Houston Bar Associations, the State Bar of Texas, the Texas Center for Legal Ethics, and the Center for Professional Responsibility. For the American Bar Association, Mr. Sparkman is an active member of the Business Law Section and its Committees on Corporate Governance; LLCs, Partnerships and Unincorporated Associations (chair, task force on model Series LLC operating agreement; chair, governance subcommittee); Mergers and Acquisitions; Middle Market and Small Business (chair, governance subcommittee); Nonprofit Organizations; and Professional Responsibility (chair, subcommittee on state and local liaisons). The Governance Subcommittees of the LLCs, Partnerships and Unincorporated Committee and the Middle Market and Small Business Committee constitute a joint subcommittee of those Committees and have joined with the

Governance of Private and Family-controlled Entities Subcommittee of the Corporate Governance Committee to form a new American Bar Association Business Law Section Task Force on Contractual Governance of Business Entities. The Task Force will be led by the named governance subcommittees of the Corporate Governance Committee, the LLCs, Partnerships, and Unincorporated Associations Committee, and the Middle Market and Small Business Committee. Mr. Sparkman is also a member of the American Bar Association Tax Law Section and Real Property, Probate and Trust Law Section.

Mr. Sparkman is a member of the Drafting Committee on Series of Unincorporated Business Entities of the National Conference of Commissioners on Uniform State Laws as an ABA Section Advisor, ABA Business Law Section.

Mr. Sparkman is a past chair of the Business Law Section of the Colorado Bar Association. Mr. Sparkman is an active member of the Ethics Committee of the Colorado Bar Association, the Colorado Secretary of State's Advisory Committee for Business and Commercial Laws, and the Legislative Drafting Committee of the Business Law Section of the Colorado Bar Association. Mr. Sparkman was the Colorado reporter for State Limited Partnership Laws and State Limited Liability Company Laws while those were published by Aspen Law & Business.

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TAX ISSUES

CARRIED INTERESTS.

A. A carried interest occurs when one or more members of an LLC have a low, or no, interest in income and expense of the LLC until the cash investors receive distributions equal to their contributions plus, sometimes, a specified return. When and if the cash investors receive distributions equal to their contributions plus any preferred return, the interest of the member or members with a carried interest will increase substantially, to 20% and sometimes more, There have been several legislative proposals over the past five or so years to tax income realized from a carried interest as ordinary income notwithstanding the character of the LLC's income that funds the carried interest. These proposals never gained much traction, and it would seem unlikely that President Trump would have any interest in pursuing them.

B. Care must be exercised if a carried interest is coupled with target capital accounts. Generally, a partner's or member's capital account is (i) increased by (a) capital contributions of cash; (b) the fair market value of property contributed (net of liabilities that the partnership is considered to assume or take subject to); and (c) allocations of profit and gain; and (ii) decreased by distributions and allocations of loss.[1] Particularly if there are multiple preferred distributions and carried interests, the drafter's task will be much simplified if cash-driven target allocations are used. An example of a company agreement provision providing for the target approach is:

> Section 4.01 *Capital Account.* The Company will maintain on its books and records a separate capital account ("Capital Account") for each Member in such a manner so as to correspond with the requirements of the Treasury Regulations under I.R.C. § 704(b) (the "Allocation Regulations"). The Capital Accounts of the Members shall be increased or decreased to reflect a revaluation of the property and assets (including intangible assets such as goodwill) on the Company's books in connection with a Revaluation Event. Upon such Revaluation: (1) the book value of property and assets shall be adjusted based on the Fair Market Value of the property and assets of the Company (taking I.R.C. § 7701(g) into account) on the Revaluation Date; (2) the unrealized income, gain, loss, or deduction inherent in such property and assets (that has not been reflected in the Capital Accounts previously) shall be allocated among the Members as if there were a taxable disposition of such property for such Fair Market Value on the Revaluation Date.

Section 4.02 *Allocations*. Except as otherwise provided herein, for purposes of any applicable federal, state, or local income tax law, rule, or regulation, items of income, gain, deduction, loss, credit, and amount realized shall be allocated to the Members as follows:

(a) except as otherwise provided by I.R.C. § 704(c) and Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4), all items of gain or loss resulting from the net income or net loss of the Company or the sale, assignment, transfer, conveyance, gift, pledge, hypothecation, or other encumbrance or any other disposition, whether voluntary, involuntary, or by operation of law Company property other than in the ordinary course of the Company's business shall be allocated for income tax purposes for each Accounting Period of the Company among the Members in such a manner as shall cause the Capital Accounts of the Members (as adjusted through the end of such fiscal year) to equal, as nearly as possible, the amounts such Members would receive if all cash on hand at the end of such Accounting Period were distributed to the Members under Section 4.03, assuming all assets owned by the Company at the end of such Accounting Period were sold for cash at the values reflected for such assets on the books of the Company, all liabilities of the Company were satisfied in cash in accordance with their terms, and any remaining cash was distributed to the Members under Section 4.03.

Target allocation agreements focus on cash and property distributions and relegate the allocation of profits and losses to a supporting role. The drafter does this by focusing on the distribution waterfall and getting it right. An example of a target provision that facially appears workable went awry for reasons explained below:

> 4.1 *Distributions*. Except as set forth in Section 4.2, the Board of Managers may (but

[1] Treas. Reg. § 1.704-1(b)(2(iv)(*b*)

shall not be obligated to) make Distributions at any time or from time to time, but only in the following order of priority:

4.1.1 first, to the holders of Series A Preferred Units (ratably among such holders based upon the aggregate Unpaid Preferred Return with respect to all outstanding Series A Preferred Units held by each such holder immediately prior to such Distribution) until the aggregate Unpaid Preferred Return with respect to each such holder's Series A Preferred Units has been reduced to zero;

4.1.2 second, to the holders of the Series A Preferred Units (ratably among such holders based upon the aggregate Unreturned Preferred Capital with respect to all outstanding Series A Preferred Units held by each such holder immediately prior to such Distribution) until the aggregate Unreturned Preferred Capital with respect to each such holder's Series A Preferred Units has been reduced to zero; and

4.l.3 third, (a) eighty percent (80%) to the holders of the Series A Preferred Units in accordance with their Percentage Interests and (b) twenty percent (20%) to [the promoter].

4.2 *Allocation of Net Profits and Net Losses*. After taking into account the special allocations set forth in this Article IV, the Net Profits and Net Losses for each Fiscal Year shall be allocated among the Members in the manner that will cause their Capital Accounts to proportionately equal, as closely as possible, the excess of (i) the amount that would be distributable to the Members under Section 11.2 if the Company were dissolved, its affairs wound up and all Company property was sold on the last day of the Fiscal Year for cash equal to its Book Value (except assets actually sold during such allocation period shall be treated as sold for the consideration received therefor), all Company liabilities were satisfied (limited, with respect to each "partner non-recourse liability" and "partner non-recourse debt," as defined in Treas. Reg. § l.704-2(b)(4) to the Book Value of the assets securing such liabilities) and the net assets were immediately distributed in accordance with Section 11.2 to the Members over (ii) such Member's share (if any) of Company minimum gain and Member non-recourse debt minimum gain (as defined in Treas. Reg. §§ l.704-2(d) and l.704-2(i)(3)), computed immediately prior to the hypothetical sale of Company property. If, in the opinion of the Board of Managers, the rules for maintaining Capital Accounts must be modified in order for the Company to comply with the requirements of the I.R.C. or the Treasury Regulations, then the method in which Capital Accounts are maintained shall be so modified.

The LLC company agreement that contained the above provisions also provided that taxable income would be allocated in the same way book income was allocated. The problem arose as follows:

- The LLC was formed early in a year.
- The LLC's assets appreciated substantially in that year and the following year, but income did not keep pace.

Under section 4.2 of the company agreement, the "as if" calculation in that section, because of the substantial increase in the value of the LLC's assets, caused book income (and, therefore, taxable income) to be allocable pursuant to the third tier of the distribution waterfall in section 4.1, that is 80 percent to the holders of the Series A Preferred Units and 20 percent to the Promoter, but all cash was still distributable to the holders of the Series A Preferred Units because cash distributions to them had not yet satisfied the first two tiers of the distribution waterfall. By the time this situation came to light, all of the LLC's available cash had been distributed to the holders of the Series A Preferred Units, and the LLC was unable to make a tax distribution to the Promoter (who had allowed many of his employees to participate in his interest in the LLC). Needless to say, the Promoter was unhappy. The problem arose because the drafter did not anticipate the possibility of the situation that developed. Had the drafter anticipated the situation, the easy fix would have been to tie book income, and thus taxable income, to the cash distributions and only use the target provision to adjust the capital accounts.

The distribution waterfall controls the manner in which cash and other property will be distributed to the partners during partnership operations and upon liquidation. During operations and before liquidation, distributions are generally not made based on capital account balances, but target allocation agreements should not ignore capital accounts. Most target agreements "true up" the partners' capital account balances at the end of each taxable year through a hypothetical liquidation in which it is assumed that all of the partnership's assets are sold for their book value and all liabilities settled in cash. The agreement then allocates profits and losses in a manner that would cause the partners' respective capital account balances to equal the amount each partner would receive under the distribution waterfall if the partnership liquidated.

Target allocation agreements do not satisfy the substantial economic effect test because they do not liquidate in accordance with positive capital account balances, and, often, they do not contain a deficit restoration obligation. Most tax practitioners believe that target allocation agreements, if administered properly, can satisfy the "partner's interest in the partnership" test[2] that applies if the capital accounts are not maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv). Some argue, however, that a target allocation agreement can satisfy the alternate test for economic effect if it contains qualified income offset language.

I. EQUITY COMPENSATION IN ALTERNATIVE ENTITIES DIFFERS FROM THE CORPORATE SETTING.

A. Tax Differences.

One key difference between equity compensation in alternative entities and in corporations derives from the fundamental difference between the tax consequences of issuing equity in exchange for services in each form of entity. Receipt of stock from a corporation in exchange for services is generally taxable, absent use of an incentive stock option plan, while receipt of interests in an LLC or partnership may be non-taxable if the interests issued are profits interests.

B. Securities Laws.

Some securities law differences exist. A share of corporate stock is always a "security."[3] Whether an interest in an LLC or partnership is a security depends on the facts and circumstances of the particular case, in particular, whether there are investors who can be said to be relying on the efforts of others.[4]

C. Document Drafting.

Document drafting in alternative entities often presents challenges not encountered in the corporate world. The flexibility afforded by alternative entity statutes prevents extensive use of forms. Attorneys should avoid using corporate terms without an understanding of how they might differ in an alternative entity. In particular, if an LLC agreement provides for compensatory interests where not all interests are outstanding, there are allocation implications. For example, can one "reserve" units for issuance later to employees—is there anything allocated or distributed prior to admission of the service provider? (income/profits must be allocated to a current member). A possible solution is for the company agreement to provide that a maximum % of interests may be granted as compensatory interests. The % interest of a particular grantee will be determined at time of grant, and any ungranted compensatory interests will either be ignored for allocation purposes or treated as owned proportionately by the other members. Stated differently, if the concept is for compensatory interests that are "granted" but do not share in allocations or receive distributions until they vest, are these interests at all (e.g., for state law or income tax purposes)? Does it matter if the service provider has made a section 83(b) election? If a compensatory interest is granted and the LLC does not intend that the interest share in allocations and distributions before vesting, that may prevent treatment of the interest as a "profits interest. However, see the materials for a program at the 2015 annual meeting of the Business Law Section of the American Bar Association: "Corporate-Like Terms: The Dangers and Pitfalls of Using Corporate Concepts."[5]

II. EQUITY COMPENSATION IN TAX PARTNERSHIPS.

A. Issuance of Interest for Services.

1. <u>Background.</u>

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. However, 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." The regulation seems to indicate 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 differed. 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 on 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.

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[2] Treas. Reg. §§ 1.704-1(b)(1)(i) and (b)(3).

[3] Securities Act of 1933 §2(a)(3)

[4] S*ee SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

[5] Available to members of the Business Law Section of the ABA on the ABA website.

2. IRS Provides Some Certainty for Planning Purposes.

a. Profits Interest Generally Not Taxable.

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 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.

b. Time of Determination.

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.

c. Contributions of Services and Cash.

What if a partnership transfers an interest intended to be a profits interest to a service provider who also makes a cash capital contribution for an interest? Under the partnership tax regulations, a taxpayer has a single capital account so arguably the profits interest would not qualify as such because upon a deemed liquidation of the partnership the service provider would receive his cash contribution. Notwithstanding that the service provider has a single capital account, the better view appears to be that if in the deemed liquidation of the partnership the only property the service provider receives is his cash capital contribution, he has received nothing in respect of his service interest and the service interest, accordingly, should qualify as a profits interest.

d. Transfer of Capital Interest.

If a partnership transfers a capital interest as compensation for services, the service provider will be taxable under IRC §83. 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.[6]

Upon receipt of the capital interest, the service provider generally should become a partner in the partnership for both state and tax law purposes.[7] 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. *Crescent Holdings, LLC v. Commissioner*[8] sheds some light on the tax consequences of issuing a capital interest. In that case, the taxpayer was granted "a 2% restricted membership interest" in Crescent Holdings LLC ("Crescent Holdings").[9] The interest was not vested when granted, and the taxpayer did not make a section 83(b) election.[10] Crescent Holdings allocated substantial amounts to the taxpayer in respect of the restricted membership interest but did not make any partnership distributions to the taxpayer.[11] In the final partnership administrative adjustments issued to Crescent Holdings, the Commissioner took the position that the taxpayer was a partner in Crescent Holdings for purposes of allocating partnership items.[12] However, at trial, the Commissioner took the position that the taxpayer was not the owner for tax purposes of the restricted membership interest.[13] After reviewing the distribution

[6] *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).

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

[8] 141 T. C. 478 (2013).

[9] 141 T. C. at 480.

[10] 141 T. C. at 481.

[11] Crescent Holdings did, after several pleas by the taxpayer, distribute money to him for taxes, but did not treat that payment as a partnership distribution. 141 T. C at 482.

[12] 141 T. C. at 484.

[13] 141 T. C. at 486.

provisions of the Crescent Holdings operating agreement, the court determined that the restricted membership interest taxpayer received was a capital interest, not a profits interest.[14] The court then stated that section 83 applied to capital interests.[15] The court then held that, pursuant to Treas. Reg. § 1.83-1(a)(1), the transferor of an unvested capital interest must include in income the undistributed allocations of income with respect to the interest.[16] 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.

If a capital interest is conveyed, 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 because it is a direct expense of acquiring or constructing a capital asset). If capitalization is required, the partnership should be entitled to recover that capitalized cost through depreciation or amortization deductions, and the partnership may want to consider allocating those deductions to partners other than the service provider.

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.[17] 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.[18] Generally, it is appropriate to "book-up" the capital accounts[19] 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. 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.[20] The timing of the payment of the tax will be at the point when the restrictions lapse. The character of the income, in part, will depend on whether the service provider made an election under Section 83(b). 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 is not treated as the owner of the capital interest until the service provider's capital interest vests.[21] This likely means that:

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[14] 141 T. C. at 490-494.

[15] 141 T. C. at 495, *citing Larson v. Commissioner,* 1988 T. C. Memo. 387.

[16] 141 T. C. at 502.

[17] *See generally, McKee, supra* note 6 at ¶ 5.08[2][b].

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

[19] *See* Treas. Reg. § 1.704-1(b)(2)(iv)*(f)*.

[20] 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.

[21] *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").

(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. If income *is* allocated to the capital interest but not distributed, the other partners will be taxed on their allocable shares of the undistributed income. *Crescent Holdings, LLC v. Commissioner*, 141 T. C. 478 (2013).

After the capital interest vests, the service provider will likely be recognized as a partner for tax purposes; the service provider's distributive share of partnership profits and losses, however, 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."[22]

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.

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 deemed capital shift of partnership assets to the service provider.[23] 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.[24]

Note: The foregoing sets forth the applicable law as of the date of finalization of this paper. Proposed Regulations relating to the issuance of partnership interests for services 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 impose new technical requirements and requirements for an election under IRC §83 to continue the liquidation-value basis for the determination of the existence of a profits interest. The required election could not be made effective before its execution.

3. Examples.

a. Assume Joe and Bill form a new LLC to purchase a building and operate a restaurant. Joe and Bill each contribute $500,000 in cash to enable the LLC to purchase the building and necessary equipment. They agree with Chuck Cook to grant Cook a 1/3 interest in the LLC in exchange for Cook's agreement to be the executive chef. Under the analysis above, so long as the LLC's operating agreement provides for liquidation in accordance with capital accounts, no more is needed for Cook's interest to be considered a profits interest. If the LLC liquidated immediately after Cook's admission as a member, Joe and Bill would each be entitled to receive back the $500,000 each had contributed, and Cook would receive nothing because he has a zero capital account at that time.

b. Assume the restaurant operates for a number of years and is very successful. Unfortunately, Chuck Cook one day eats some bad mushrooms and dies. Cook's heirs receive the buy-out provided by the operating agreement, and Joe and Bill begin looking for another executive chef. They make a deal with Jane Goodcook to become a 1/3 member in exchange for her agreement to serve as executive chef. Assume that the restaurant building has appreciated in value to $10,000,000, and an appraisal of the LLC

[22] *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"). The regulations do not, however, specifically address the tax ownership of property with respect to which a Section 83(b) election has been made, and this situation was not before the court in *Crescent Holdings* as the restricted membership interest in that case never vested.

[23] *See* text accompanying notes 17-19, *supra*.

[24] Treas. Reg. § 1.83-1(a)(1).

performed in connection with the buy-out of Chuck Cook's interest found that it had a total value of $15,000,000, including the building, goodwill, and intellectual property that has been developed for the LLC. Unlike the first example, unless the operating agreement provides that the members' capital accounts will be booked up immediately before the admission of Goodcook, if the LLC were to liquidate immediately after Goodcook's admission, Joe, Bill, and Goodcook each would be entitled to receive $5,000,000. Not only would this result in Goodcook realizing $5,000,000 of ordinary income, this allocation of pre-existing value to Goodcook almost certainly is not what Joe and Bill desire or intend.

4. Alternative to Booking Up.

Clients sometimes prefer to avoid the technical booking up procedure in the regulations. An alternative that achieves the same economic result is as follows:

> The Class B Membership Interests are intended to constitute "profits interests" as that term (or any term of similar import) is used in Internal Revenue Service Revenue Procedure 93-27, 1993-2 C. B. 343 and Revenue Procedure 2001-43, 2001-2 C. B. 191, and any successor provisions of the Code, Treasury Regulations, IRS Revenue Procedures or Revenue Rulings, or other administrative notices or announcements, with the intended results that:
>
> (A) no compensation or other income shall be recognized by an owner of the Class B Membership Interests by reason of the issuance of such Class B Membership Interests; and
>
> (B) no compensation expense shall be deducted by the Company by reason of the issuance of such Class B Membership Interests. The Managers shall designate a threshold value, not less than zero (such value, the "**Threshold Value**") applicable to each Class B Membership Interest to the extent necessary to cause such Class B Membership Interest to constitute a "profits interest" as provided in this Section. The Class B Membership Interests to be issued on the date of this Agreement (if any) have a Threshold Value of $[___]. The Threshold Value for each additional Class B Membership Interest issued after the date of this Agreement shall equal the amount that would, in the reasonable determination of the Managers, be distributed with respect to existing Members with respect to their Economic Interests if, immediately prior to the issuance of such additional series Class B Membership Interests the assets of the Company were sold for their fair market values and the proceeds (net of any liabilities of the Company) were distributed pursuant to Section _____.

B. Issuance of Options and Other Interests by LLCs.

Although a less frequent occurrence than the issuance of profits interest, LLCs might also issue options to acquire membership interests in exchange for services. The proposed regulations referenced above would apply IRC §83 to the issuance of compensatory options by LLCs. As discussed below in connection with the issuance of options by corporations, section 83 generally does not apply to the grant of an option. Upon exercise of a compensatory option, the service provider recognizes income if the property received is substantially vested or if the service provider makes a section 83(b) election. LLCs may also have plans that provide compensation on a basis similar to that provided by corporations under Phantom Stock Plans and Stock Appreciation Rights.

III. IRC 409A.

A. IRC §409A and Restricted Stock, Stock Options and SARs.

IRC §409A provides for the inclusion in income and the imposition of an extra 20% tax on compensation deferred under a nonqualified deferred compensation plan. Section 409A does not apply to incentive stock options.[25] Section 409A also does not apply to other stock options granted to service providers if the exercise price of the option may never be less than the fair market value of the underlying stock on the date of grant, the number of shares is fixed on the original date of grant of the option, the transfer or exercise of the option is taxable under IRC §83 and the option does not include any feature for the deferral of compensation other than the deferral of recognition of income until the later of (i) the exercise or disposition of the option under Treas. Reg. §1.83-7 or (ii) the date the stock acquired pursuant to exercise of the option first becomes substantially vested as defined in Treas. Reg. 1.83-3(b). If an employer issues restricted stock pursuant to a plan, there is no deferral of compensation for purposes of IRC §409A merely because the restricted stock is substantially nonvested as defined in Treas. Reg. §1.83-

[25] Treas. Reg. §1.409A-1(b)(5)(ii).

3(b) or is includible in income solely because of a valid election under section 83(b).[26] Finally, IRC §409A does not apply to a stock appreciation right if the compensation payable under the stock appreciation right cannot be greater than the excess of the fair market value of the stock on the date the stock appreciation right is exercised over an amount specified on the date the stock appreciation right is granted with respect to a number of shares fixed on or before the date the right is granted, the exercise price of the right may never be less than the fair market value of the underlying stock on the date the right is granted and the stock appreciation right does not include any feature for the deferral of income other than the deferral of recognition until the exercise of the stock appreciation right.[27]

B. IRC §409A and Partnership Interests.

Section III G of the preamble to the final regulations under section 409A, TD 9321 states:

> Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and section II. E. of the preamble to the proposed regulations. Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.

FEDERAL TAX ISSUES—FORMATION AND OPERATION.

I. FORMATION.

A. Tax partnerships can generally be formed tax-free.[28] There are certain exceptions; the two that seem most likely to be applicable in a business formation setting are the disguised sale rules and the anti-mixing bowl rules.

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.[29] 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.[30]

Anti-Mixing Bowl Rules. If property 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 (that is, net pre-contribution gain).[31] 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 (i) the net pre-contribution 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).[32] “Net pre-contribution gain” means gain on property held by the partnership for less than seven years.[33]

B. I.R.C. § 351 governs the federal income tax consequences of contributing property to a corporation (whether a C corporation or an S corporation). 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 § 351(a) are that the transfer must be a transfer of “property” “solely in exchange for stock” and immediately after the

[26] Treas. Reg. §1.409A-1(b)(6).

[27] Treas. Reg. §1.409A(1)(b)(5)(B).

[28] I.R.C. § 721(a).

[29] I.R.C. § 707(a)(2)(B).

[30] Treas. Reg. § 1.707-3(c)(1).

[31] I.R.C. § 704(c)(1)(B).

[32] I.R.C. § 737(a).

[33] I.R.C. § 737(b).

> 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.[34]

Section 351 defines "control" as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.[35] In comparison to the partnership rule under § 721, the "control" requirement of § 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. For example, if a shareholder conveys appreciated real estate to an existing corporation in exchange for cash, the shareholder will recognize gain on the sale of the appreciated real estate to the extent the net sales price of the appreciated real estate exceeds the shareholder's basis in the real estate. Similarly, if the shareholder receives stock from the corporation in exchange for the appreciated real estate, the shareholder will recognize the same gain *unless* the number of shares issued to the shareholder (together with any other shares he or she may then own) give the shareholder control of the corporation for § 351 purposes. In that case, the contribution to the corporation would be tax free to the contributing shareholder and the shareholder's basis in his or her shares would be equal to the shareholder's basis in the contributed property.[36] The following table illustrates these principles:

	Sale for Cash	Sale for Stock without Control	Sale for Stock with Control
Appreciated Asset (basis is $1,000,000)	$2,000,000	$2,000,000	$2,000,000
Shares already owned	Not relevant	0	600,000
Shares Issued (%)	0 (0%)	200,000	200,000
% owned following transaction	Not relevant	20%	80%
Tax obligation (20% rate assumed)[37]	$200,000	$200,000	$0
Net cash after taxes	$1,800,000	$(200,000)	$0
Basis in shares	Not relevant	$2,000,000	$1,000,000

If an owner of real estate instead contributes the real estate to an existing LLC for an interest in the LLC, the transfer of real estate will be non-taxable under § 721 no matter what percentage interest in the LLC he or she receives.[38]

Section 351's requirement that there be a transfer of property generally does not create a problem, but stock issued for services is not considered issued for property for purposes of § 351. For example, if A, B, and C form a new corporation and A transfers land to the corporation for 30 percent of the stock, B transfers cash for 40 percent of the stock, and C receives 30 percent of the stock for C's agreement to manage the development of the land, A's transfer of land will not be a tax-free transaction.

Section 351 is potentially applicable to avoid recognition of gain in the contribution of appreciated property at the time an LLC is formed and elects corporate tax treatment. Section 351 is also generally applicable when an operating LLC subsequently elects corporate tax treatment or converts into a corporation

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[34] I.R.C. § 351(b).

[35] I.R.C. §§ 351(a) and 368(c).

[36] I.R.C. § 1001(a). The corporation, however, will not recognize gain or loss on the issuance of its stock. I.R.C. § 1032.

[37] Individual long-term capital gain rate assumed to be applicable. Potential effect of state taxes ignored.

[38] Subject to I.R.C. § 704(c) and the disguised sale and anti-mixing bowl rules. See text accompanying notes 30-33, *supra*.

(as is permitted under Texas law[39]). Thus, if an LLC with appreciated property becomes taxable as a corporation, the LLC and its members will recognize no gain or loss on the deemed contribution to the corporation if the requirements of § 351 are satisfied.

On the other hand, the author knows from his legal practice of situations in which LLCs did not go through with planned conversions because of the unavailability of the non-recognition provisions of § 351. In these cases, the LLCs had issued to their employees a large number of service warrants to acquire LLC units that would become exercisable at very favorable prices immediately before the conversions. If, as management of the LLCs expected, all of the service warrants were exercised, that would have caused the resulting corporations to have issued more than 20 percent of its stock to those employees. If, as is likely, the IRS took the position that, the employees' service warrants having been exercised on account of and immediately before the conversions, the stock issued to the employees in the conversions would be considered issued for services, the conversions would not have been tax free. The transferors of property (the other LLC members) would not have acquired 80 percent of the stock of the resulting corporations and therefore would not have satisfied the requirement of § 351 that the transferors of property be in control of the corporations.

II. TAXATION OF OPERATIONS.

A. Partnerships and LLCs that are taxed as partnerships are flow-through entities for federal income tax purposes.[40]

Except as discussed in B "New Partnership Audit Rules and Assessments of Tax Against Partnerships," below, as a flow-through entity, a partnership is not subject to tax. A partnership files an information return (Form 1065) with the IRS, but its income, gains, losses, deductions, and credits are passed through according to their categories listed in I.R.C. § 702(a), and each partner receives a Form K-1 from the partnership from which the partner reports his or her distributive share of each category on the partner's income tax return. A partner must include in income the partner's distributive share of partnership income for each partnership taxable year ending within or with the partner's taxable year.[41] 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," however, it is disregarded for federal tax purposes, and each partner's distributive share of that item for federal tax purposes is determined according to the partner's interest in the partnership.[42] Note that this is a partner's "distributive" share of partnership income, not an actual distribution of cash or other property to the partner. A partner is taxed on the net taxable income of the partnership allocated to that partner, whether or not any cash or other property is distributed. Partnership distributions generally are not taxable.

B. New Partnership Audit Rules and Tax Assessments Against Partnerships.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") changed the procedures applicable to audits of partnerships and partners so that all audits of partnership items were conducted in a unified procedure at the partnership level.[43] TEFRA required partners to treat partnerships items on the partners' returns consistently with the treatment of the same items on the partnership's return or notify the IRS of any inconsistencies.[44] The TEFRA provisions do not apply to partnerships which have ten or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.[45] For purposes of this exception, a married couple is treated as one partner.[46]

Public Law 114-74, the Bipartisan Budget Act of 2015 (the "2015 Act") dramatically changes the TEFRA rules effective for partnership taxable years beginning after December 31, 2017. The 2015 Act applies to all partnerships except those having 100 or fewer partners all of whom are individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic entities, S corporations, or estates of deceased partners. Although S corporations are permitted partners, each of an S corporation partner's shareholders will be treated as a partner for purposed of applying the 100 partner limit. To take advantage of this exemption for partnerships with fewer than 100 partners, a partnership must file an election pursuant to I.R.C § 6221(b).

The default rule under the 2015 Act is that in the case of any audit adjustments to the partnership's income, the IRS will not assess individual partners but will assess the partnership for what the 2015 Act terms the partnership's "imputed underpayment."[47] The assessment will be at the highest individual or corporate

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[39] TBOC § 10.101.

[40] I.R.C. § 701; Treas. Reg. § 301.7701-3(b)(1)(ii).

[41] I.R.C. § 706(a).

[42] Treas. Reg. §§ 1.704-1(b)(1) and (b)(3).

[43] I.R.C. §6221 (1982).

[44] I.R.C. §6222 (1982).

[45] I.R.C. §6221(a)(1)(B)(i) (1982).

[46] *Id*.

[47] I.R.C. § 6225(a) (2015).

rate,[48] but the 2015 Act requires the IRS to establish procedures by regulation providing for a lower rate in certain circumstances.[49] The assessment against a partnership will be for the year of the adjustment, not the year to which the adjustments related.[50] This means that current partners may be liable for erroneous tax benefits garnered by former partners. The 2015 Act provides two exceptions for avoiding this result:

- The partnership's imputed underpayment may be reduced by the portion of adjustments that individual partners take into account and for which they pay associated taxes. This exception requires that, within 270 days of receiving a notice of a proposed partnership adjustment, partners must file amended tax returns reporting their distributive shares of the partnership adjustments and pay all related taxes.[51]
- Within 46 days of receiving a final notice of partnership adjustment, a partnership may elect to issue to each prior year partner and to the IRS a statement of the partner's share of any adjustment to income, gain, loss, deduction, or credit as determined in the final notice of partnership adjustment of partnership adjustment. Thereafter, each partner is responsible for the adjusted amounts so reported, not the partnership.[52]

Unless a partnership is exempt from these new rules, it must appoint a partner or other person as the partnership representative pursuant to I.R.C. § 6223(a).

Importantly, the restrictions on the exemption for partnerships with no more than 100 partners mean that a partnership of any size that has another partnership or LLC as a partner, or a trust or a nonresident alien as a partner will be subject to the new rules described above. This means that many partnerships, not just those with more than 100 partners, will want their partnership agreements to contain provisions requiring partners to pay their allocable share of any final partnership adjustments and to indemnify the partnership and the other partners against their failure to do so.

If a partnership is exempt because it has fewer than 100 partners, audits of the partnership's income will be governed by the rules in effect before TEFRA. This means that if the IRS adjusts the partnership's income for a taxable year, it must also adjust the income of each partner for that year. It is an open question whether the expansion of the number of partnerships exempt from the unified audit procedures will so tax the resources of the IRS that Congress may revisit the decisions it made in Public Law 114-74.

C. C corporations.

In 2017, the taxable income of C corporations is taxed at the following rates (regardless of the character of the income):

1) 15 percent of taxable income not in excess of $50,000;
2) 25 percent of taxable income over $50,000 but not over $75,000;
3) 34 percent of taxable income over $75,000 but not over $10 million; and
4) 35 percent of taxable income in excess of $10 million.[53]

If a corporation has taxable income in excess of $100,000, the amount of tax imposed is increased by the lesser of (i) 5 percent of such excess or (ii) $11,750. In addition, if a corporation has taxable income in excess of $15 million, the amount of tax is further increased by the lesser of (i) 3 percent of the taxable income in excess of $15 million or (ii) $100.000.

All taxable income of qualified personal service corporations is taxed at 35 percent.[54] A qualified personal service corporation is a corporation substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and substantially all of the stock of which is held directly or indirectly by employees performing services for the corporation in connection with a specified field, by retired employees who had performed such services, by the estate of such an employee, or by certain heirs or devisees.[55]

The taxes imposed by I.R.C. § 11(b)(1) do not apply to a corporation subject to a tax imposed by § 594 (relating to mutual savings banks conducting life insurance business), subchapter L (§ 801 and following, relating to insurance companies), or subchapter M (§ 851 and following, relating to regulated investment companies and real estate investment trusts).[56]

In the case of foreign corporations, the taxes imposed by §§ 11(b)(1) and 55 (alternative minimum tax) apply only as provided in § 882.[57]

[48] I.R.C. § 6225(b) (2015).

[49] I.R.C. § 6225(c)(1) (2015).

[50] I.R.C. § 6225(a)(2) (2015).

[51] I.R.C. § 6225(c)(2) (2015).

[52] I.R.C. § 6226 (2015).

[53] I.R.C. § 11(b)(1).

[54] I.R.C. § 11(b)(2).

[55] I.R.C. § 448(d)(2).

[56] I.R.C. § 11(c).

[57] I.R.C. § 11(d).

D. S corporations.

With certain exceptions not applicable to newly formed S corporations that have never been C corporations, S corporations are flow-through entities for federal income tax purposes. Distribution of some of the S corporation's profits as dividends instead of salaries will mitigate the impact of employment taxes because such taxes are not applicable to dividends. On the other hand, contributions to qualified plans must be based on salaries, not dividends. Therefore, a shareholder who performs services for the S corporation cannot sustain an argument that all his or her income from the corporation should be characterized as a dividend. A shareholder of an S corporation who performs substantial services for the corporation is considered an employee. Thus, reasonable compensation for such services is subject to FICA, FUTA, and income-tax withholding.[58] See III under Employment Taxes, below. For purposes of "employee fringe benefits," S corporations are treated as partnerships, and any 2 percent shareholder is treated as a partner.[59]

EMPLOYMENT TAXES

Employment taxes apply differently to corporate employees, shareholder-employees of S corporations, members of LLCs, and partners and limited partners of partnerships.

I. C CORPORATIONS.

Salaries paid by a corporation are subject to employment taxes that are required under the Federal Insurance Contributions Act (FICA). FICA consists of two separate taxes: the Social Security tax and the Medicare tax. For 2017, the employee pays 7.65 percent on the first $127,200 (both taxes combined) and 1.45 percent (the Medicare tax) on any excess. The corporation must pay a corresponding amount.[60]

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act (PPACA), provides that individuals who have in excess of $250,000 of wages (joint return filers, $125,000 for married taxpayers filing separate returns; $200,000 for other taxpayers) will owe an extra 0.9 percent hospital insurance (HI) tax.[61] Although the employer is not liable for the extra HI tax, an employer is required to withhold the extra HI tax from the wages of a taxpayer who receives more than $200,000 in wages from the employer.[62]

In addition, a federal unemployment tax of 6.2 percent applies to the first $7,000 per year of "wages."[63]

II. SHAREHOLDER-EMPLOYEES OF S CORPORATIONS.

In an S corporation, salary paid to an owner-employee is subject to FICA and to the other taxes discussed in II, above. Any profits of the S corporation allocated to the owner-employee over and above the owner's salary are not subject to FICA. Conversely, in most situations (although the IRS has not issued final guidance), all of the net amount allocated to an LLC member may be subject to SECA (the self-employment version of FICA), and an LLC does not have the option to subdivide those allocations between salary and allocations not subject to self-employment tax.

This may lead to the temptation to make an S corporation election and allocate $1 per year to salary and take the balance as allocated profits. Such an action will spark IRS interest and likely lead to a reallocation of the split away from an overly-aggressive position of the taxpayer. For example, in *David E. Watson, P.C. v. United States*,[64] the court considered a case in which a professional shareholder in an S corporation was paid a "salary" of $24,000 per year and received "distributions" of $118,159 in 2002 and $221,577 in 2003. At trial, the IRS established that the reasonable amount of remuneration for Watson's services in both 2002 and 2003 was $91,044, or $67,044 more than Watson reported.[65] Thus, even after the IRS adjustments approved by the court, the taxpayer saved employment taxes on tens of thousands of dollars in both years.

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[58] *See also David E. Watson, P.C. v. United States*, 714 F. Supp. 954 (S.D. Iowa 2010); *Spicer Accounting v. United States*, 918 F.2d 90 (9th Cir. 1990); *Dunn & Clark, P.A. v. United States*, 853 F. Supp. 365 (D. Idaho 1994); IRS Pub. #589, "Tax Information on S Corporations," *see also* P.L.R. 9530005 (April 26, 1995).

[59] I.R.C. § 1372.

[60] I.R.C. §§ 3101 and 3111.

[61] I.R.C. § 3101(b)(2).

[62] I.R.C. § 3102(f)(1). The employer may disregard wages paid to the taxpayer's spouse. If the employer does not withhold the 0.9 percent tax, the employee is liable to pay the tax, and the employer may be liable for penalties.

[63] I.R.C. §§ 3301 and 3306.

[64] *David E. Watson, P.C. v. United States*, 757 F. Supp. 2d 877 (S.D. Iowa 2010); *see also Spicer Accounting v. United States*, 918 F.2d 90 (9th Cir. 1990); *Dunn & Clark, P.A. v. United States*, 853 F. Supp. 365 (D. Idaho 1994); IRS Pub. #589, "Tax Information on S Corporations;" *see also* P.L.R. 9530005 (April 26, 1995).

[65] 757 F. Supp. 2d at 891. For a discussion of *Watson* and other cases, see Timothy M. Todd, "Multiple-Entity Planning to Reduce Self-Employment Taxes: Recent Cases Demonstrate the Pitfalls and How to Avoid Them," *J. of Tax Practice & Procedure* 31 (April-May 2011).

III. PARTNERS, SELF-EMPLOYED INDIVIDUALS, AND DISREGARDED ENTITIES.

Like sole proprietors and owners of single-member LLCs, members of an LLC or other entity treated as a partnership for tax purposes are generally required to treat their distributive share of ordinary income and loss as NESE subject to Old-age, Survivors, and Disability Insurance (OASDI) tax.[66] NESE does not include rent,[67] gain or loss from disposition of property,[68] or investment income.[69]

The self-employment tax assessed against NESE consists of two components: (1) a 12.4 percent tax for OASDI; and (2) a 2.9 percent HI tax.[70] For 2017, the OASDI component of the self-employment tax applies to the first $127,200 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.[71] The PPACA provides that 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 percent HI tax.[72]

NESE 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.[73] A limited partner's distributive share of income or loss (other than guaranteed payments under I.R.C. § 707(c)) is excluded from the definition of "net earnings from self-employment."[74]

From a tax-planning perspective, it is important to note that the self-employment tax assessed against NESE is at the same rate (15.3 percent) as the total of the FICA tax assessed against the corporate employee and the corporation, and the limits are the same ($118,500). For earnings above the limit, the Medicare tax (1.45 percent each paid by the employee and the corporation plus the extra 0.9 percent HI tax owed by certain employees) is equal to the HI tax against NESE.

IV. LIMITED PARTNERS.

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.[75] 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 I.R.C. § 707(c)), regardless of whether the limited partner is actively engaged in the day-to-day operations of the limited partnership.[76]

V. SELF-EMPLOYMENT TAX AND DISREGARDED ENTITIES.

A single-member LLC that is disregarded for income tax purposes is regarded for employment tax purposes.[77] A disregarded entity that has employees is responsible for reporting and paying employment taxes on its employees as if it were a corporation.[78] An individual who is the owner of a disregarded entity, however, is responsible for paying self-employment tax on his or her income from self-employment derived from the disregarded entity.[79]

In May 2016, the Treasury Department issued temporary and proposed regulations clarifying this rule and also clarifying that if a partnership is the owner of a disregarded entity, the disregarded entity is not treated as the employer of any partner of such partnership. Accordingly, the partner remains responsible for the partner's self-employment tax on income from self-employment derived from the disregarded entity.[80]

VI. GENERAL PARTNER OR LIMITED PARTNER FOR SELF-EMPLOYMENT TAX PURPOSES.

As noted in the previous section, in some circumstances for self-employment tax purposes, the tax rules treat general partners differently than limited partners, so the distinction is important. The distinction

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[66] I.R.C. § 1402(a); Treas. Reg. § 1.1402(a)-1(b).

[67] I.R.C. § 1402(a)(1); Treas. Reg. § 1.1402(a)-4.

[68] Treas. Reg. § 1.1402-2(a)(6).

[69] I.R.C. § 1402(a)(2); Treas. Reg. § 1.1402(a)-5.

[70] I.R.C. § 1401.

[71] I.R.C. § 1402(b).

[72] I.R.C. § 1401(2)(b).

[73] I.R.C. § 1402(a).

[74] I.R.C. § 1401(a)(13).

[75] Amendment to the Social Security Act and the Internal Revenue Code of 1954, Pub. L. No. 95-216, 91 Stat. 1509 (1977).

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

[77] Treas. Reg. § 301.7701-2(c)(2)(iv)(1996).

[78] *Id*.

[79] *Id*.

[80] Temp. Treas. Reg. § 301.7701-2T(c)(2)(iv)(C)(*2*) (2016).

is easy with respect to state-law limited partnerships. The general partner is a general partner; limited partners are limited partners for tax purposes.

The self-employment tax rules in the I.R.C. do not, however, classify members of an LLC as general or limited partners. This circumstance results largely from the fact that the I.R.C. does not address LLCs — LLCs are classified as partnerships if there are two or more owners, unless an election is made to be an association taxable as a corporation or, if there is only one owner, they are disregarded except for employment taxes on employees, unless, again, an election is made to be an association taxable as a corporation. To address this issue, the IRS issued proposed regulations in 1994 and 1997.

VII. 1997 PROPOSED REGULATIONS.

In 1997, in response to comments made on the 1994 proposed regulation, the IRS withdrew the 1994 proposed regulations and issued new proposed regulations (1997 Proposed Regulations).[81] 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:

1) Has personal liability for the debts of or claims against the partnership (Liability Test);
2) Has authority to contract on behalf of the partnership pursuant to the law under which the partnership is organized (Authority Test);
3) Participates in the partnership's trade or business for more than 500 hours during the taxable year (Participation Test); or
4) Provides more than a *de minimus* amount of services to or on behalf of a 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 (Personal Services Test).

VIII. 1997 PROPOSED REGULATIONS STILL PROPOSED.

The 1997 Proposed Regulations, while generally clear, rational, and fair, drew a firestorm of criticism from Congress and others 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 that would be characterized as a limited partnership interest under state law not to be treated as a limited partner for purposes of determining NESE. *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 St. J.*, May 5, 1997, at A18, Column 1.

In response to this criticism, § 935 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997), imposed a moratorium that prevented the IRS from finalizing the 1997 Proposed Regulations until July 1, 1998. Although the moratorium expired, the IRS has taken no action to finalize or withdraw the 1997 Proposed Regulations.

IX. WHAT SHOULD BE DONE?

Current law still provides clear answers for partnerships and state law limited partnerships.[82] However, regardless of how ill-advised Congressional and IRS inaction on self-employment tax regulations may be, individual members of LLCs still must determine how they will treat their distributive share of ordinary income from their LLC. As a result of the now-expired moratorium following the issuance of the 1997 Proposed Regulations and subsequent inaction, there is no formal authority with respect to the appropriate treatment of a member's distributive share. This means that members and their advisers will have to determine how to account for self-employment 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 (NESE) by § 1402(a)(13)."[83] 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 should use S corporations — either corporations that make an election to be treated under subchapter S of the I.R.C., or LLCs that elect to be treated as an association taxable as a corporation and also elect to be an S corporation.

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

[81] Proposed Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (Jan. 13, 1997).

[82] Except perhaps for some uncertainty caused by the Tax Court's opinion in *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 T.C. 137 (Feb. 9, 2011).

[83] P.L.R. 9432018, 9452024, and 9525058.

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.[84]

A third alternative is to assume that the 1997 Proposed Regulations are close to what the final regulations for LLCs will look like, and to draft and report based on a reading of those regulations. The dissension over the 1997 Proposed Regulations 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.[85] That being the case, it seems reasonable to assume that regardless of the 1997-1998 disagreement between Congress and the IRS, the final regulations (if ever adopted) will resemble or be more generous than the 1997 Proposed Regulations. As we note above, there is no authority for this position (or for the proposition that in absence of regulations, a taxpayer may take "any reasonable position"). An advisor considering applying the 1997 Proposed Regulations should carefully consider the uncertainties raised by the cases and other authority we discuss in § 13.7.5 "Conclusion—And Perhaps an Answer—But Maybe Not the Answer Wanted."

In considering whether to give effect to proposed regulations, it is important to note that, under Treasury Regulations § 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.[86] The taxes imposed on NESE, however, are not "income taxes." As a result, the substantial authority rules do not apply to the determination of NESE. 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, "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."[87] Following the decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*,[88] which arguably called into question whether the 1997 Proposed Regulations are valid, IRS special counsel Dianna Mosi, speaking at the May 2011 American Bar Association Section of Taxation meeting, stated that taxpayers "can rely" on the 1997 Proposed Regulations.[89] In any case, as in all areas in which there is uncertainty, the ultimate decision should be made by an informed client.

If an LLC's members decide to report on the basis of the 1997 Proposed Regulations, advisors should note important distinctions between manager-managed LLCs and member-managed LLCs. Under the LLC Chapter, if an LLC is member-managed, each member is an agent of the LLC for purposes of carrying on its business in the ordinary course.[90] Accordingly, under the Authority Test, each member of a member-managed LLC will be classified as not being a limited partner and therefore subject to self-employment tax on the self-employment income of the LLC allocated to such member. If an LLC is manager-managed, each manager will be will be an agent of the LLC[91] and therefore classified as not being a limited partner and subject to self-employment tax on the self-employment income of the LLC allocated to the manager (assuming the manager is a member). Of course, a member who avoids the Authority Test may nevertheless be classified as not being a limited partner under the Participation Test or the Personal Services Test or, in rare cases, under the Liability Test.

[84] *Id.*

[85] The 1997 Proposed Regulations, while generally clear, rational, and fair, drew a firestorm of criticism from Congress and others 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 that would be characterized as a limited partnership interest under state law not to be treated as a limited partner for purposes of determining NESE. *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 St. J.*, May 5, 1997, at A18, Column 1.

[86] I.R.C. § 6662(d)(2)(B).

[87] 114 BNA's *Daily Tax Report* (June 13, 2003) at G-3, reported in John Cunningham's LLC Newsletter (Issue No. 19, May 5, 2005) *available at* www.llcformations.com/pdf/Issue%2019%20-%20Can%20you%20rely%20on%20the%20Prop.%20Reg%20-%205-5-05.pdf. Ms. Clark's statement is not binding on the IRS.

[88] *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 T.C. 137 (Feb. 9, 2011).

[89] Laura E. Erdman, "Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base," 70 *Wash. & Lee L. Rev.* 2389, 2436 (2013) (explaining that Ms. Mosi's statement is not binding on the IRS).

[90] TBOC § 101.254.

[91] *Id.*

FRANCHISE TAX

I. FRANCHISE TAX IN GENERAL.

The Texas Franchise Tax is imposed by the Texas Tax Code §§ 171.0001 et seq. The Texas Comptroller of Public Accounts describes the franchise tax as "a privilege tax imposed upon each taxable entity formed or organized in Texas or doing business in Texas."[92] The franchise tax applies to corporations, LLCs, including single-member LLCs, general partnerships other than general partnerships that are composed entirely of individuals that are not LLP, and limited partnerships. Limited partnerships and general partnerships may be exempt if they meet the definition of passive entity.

II. FRANCHISE TAX RATES.

The franchise tax is imposed at a rate of 0.75% of taxable margin except for taxable entities primarily engaged in retail or wholesale trade.[93] Taxable margin is defined as:

> Sec. 171.101. DETERMINATION OF TAXABLE MARGIN. (a) The taxable margin of a taxable entity is computed by:
>
> (1) determining the taxable entity's margin, which is the lesser of:
>
> (A) the amount provided by this paragraph, which is the lesser of:
>
> (i) 70 percent of the taxable entity's total revenue from its entire business, as determined under Section 171.1011; or
> (ii) an amount equal to the taxable entity's total revenue from its entire business as determined under Section 171.1011 minus $1 million; or
>
> (B) an amount computed by determining the taxable entity's total revenue from its entire business under Section 171.1011 and subtracting the greater of:
>
> (i) $1 million; or
> (ii) an amount equal to the sum of:
>
> (a) at the election of the taxable entity, either:
>
> (1) cost of goods sold, as determined under Section 171.1012; or
> (2) compensation, as determined under Section 171.1013; and
>
> (b) any compensation, as determined under Section 171.1013, paid to an individual during the period the individual is serving on active duty as a member of the armed forces of the United States if the individual is a resident of this state at the time the individual is ordered to active duty and the cost of training a replacement for the individual;
>
> (2) apportioning the taxable entity's margin to this state as provided by Section 171.106 to determine the taxable entity's apportioned margin; and
> (3) subtracting from the amount computed under Subdivision (2) any other allowable deductions to determine the taxable entity's taxable margin.
>
> (c) Notwithstanding Subsection (a)(1)(B)(ii)(a), a professional employer organization may subtract only the greater of $1 million as provided by Subsection (a)(1)(B)(i) or compensation as determined under Section 171.1013.

III. NO TAX DUE THRESHOLD.

A taxable entity is not required to pay any tax and is not considered to owe any tax for a period if:

- The amount of the tax computed for the taxable entity is less than $1,000; or
- The amount of the taxable entity's total revenue from its entire business is not more than $1,000,000 or the amount determined under Texas Tax Code §

[92] www.comptroller.texas.gov/taxes/franchise.

[93] TEX. TAX CODE § 171.002.

> 171.006 for the 12-month period on which margin is based.[94]

The $1,000,000 no tax due threshold in section 171.002(d) is adjusted as follows:

> Beginning in 2010, on January 1 of each even-numbered year, the amounts prescribed by Sections 171.002(d)(2) and 171.1013(c) are increased or decreased by an amount equal to the amount prescribed by those sections on December 31 of the preceding year multiplied by the percentage increase or decrease during the preceding state fiscal biennium in the consumer price index and rounded to the nearest $10,000.[95]

The no tax due threshold for 2016 and 2017 is $1,100,000.[96]

IV. EXEMPTION FOR PASSIVE ENTITIES.

A passive entity is not subject to margin tax.[97] A passive entity is a general or limited partnership or a trust other than a business trust and during the period on which margin is based, the entity's federal gross income consists of at least 90 percent of the following income:

> (A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;
> (B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;
> (C) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and
> (D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and
>
> > (3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.[98]

V. FORFEITURE OF CORPORATE PRIVILEGES.

Texas Tax Code §§ 171.251, 255(b) provide for the forfeiture of a corporation's corporate privileges or the forfeiture of the right to transact business in Texas of other "taxable entities." A taxable entity includes partnerships (with some exceptions) and LLCs. If a forfeiture for franchise tax purposes occurs, Tax Code § 171.255 provides that each director or officer of the corporation is liable as if the director or officer were a partner and the corporation were a partnership "for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived. Tax Code § 171.2515(b) makes § 171.255 applicable in the case of the forfeiture of a taxable entity's right to transact business in Texas. Presumably, each governing person of an LLC or partnership would be treated as a director.

VI. NOTICE OF INTENT TO FORFEIT OF CORPORATE PRIVILEGES.

If the comptroller proposes to forfeit the corporate privileges of a corporation, the comptroller shall notify the corporation that the forfeiture will occur without a judicial proceeding unless the corporation:

> (1) files, within the time established by Section 171.251 of this code, the report to which that section refers; or
> (2) pays, within the time established by Section 171.251 of this code, the delinquent tax and penalty to which that section refers.
>
> > (b) The notice shall be written or printed and shall be verified by the seal of the comptroller's office.
> > (c) The comptroller shall mail the notice to the corporation at least 45 days before the forfeiture of corporate privileges. The notice shall be addressed to the corporation and mailed to the address named in the corporation's charter as its principal place of business or to another known place of business of the corporation.
> > (d) The comptroller shall keep at the comptroller's office a record of the date on which the notice is mailed. For the purposes of this chapter, the notice and the record of the mailing date constitute

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[94] TEX. TAX CODE § 171.002(d).

[95] TEX. TAX CODE § 171.006(b).

[96] www.comptroller.texas.gov/taxes/franchise.

[97] TEX. TAX CODE § 171.002(a).

[98] TEX. TAX CODE § 171.003(a).

legal and sufficient notice of the forfeiture.[99]

VII. REVIVAL OF CORPORATE PRIVILEGES.

Section 171.258 of the Tax Code provides:

> The comptroller shall revive the corporate privileges of a corporation if the corporation, before the forfeiture of its charter or certificate of authority, pays any tax, penalty, or interest due under this chapter.

VIII. FORFEITURE OF CHARTER OR CERTIFICATE OF AUTHORITY.

Section 171.301 of the Tax Code provides:

> It is a ground for the forfeiture of a corporation's charter or certificate of authority if:
>
> (1) the corporate privileges of the corporation are forfeited under this chapter and the corporation does not pay, within 120 days after the date the corporate privileges are forfeited, the amount necessary for the corporation to revive under this chapter its corporate privileges; or
> (2) the corporation does not permit the comptroller to examine the corporation's records under Section 171.211 of this code.

Section 171.3015 of the Tax Code provides:

> The comptroller may, for the same reasons and using the same procedures the comptroller uses in relation to the forfeiture of a corporation's charter or certificate of authority, forfeit the certificate or registration of a taxable entity.

IX. JUDICIAL FORFEITURE.

After 120days after the forfeiture of a corporation's privileges, "the comptroller shall certify the name of the corporation to the attorney general and the secretary of state."[100] "On receipt of the comptroller's certification, the attorney general shall bring suit to forfeit the charter or certificate of authority of the corporation if a ground exists for the forfeiture of the charter or certificate."[101] Section 171.304 of the Tax Code provides for a record of a judicial forfeiture and notice of same to the Secretary of State.

X. REVIVAL OF CHARTER OR CERTIFICATE OF AUTHORITY AFTER JUDICIAL FORFEITURE.

Section 171.305 of the Tax Code provides:

> A corporation whose charter or certificate of authority is judicially forfeited under this chapter is entitled to have its charter or certificate revived and to have its corporate privileges revived if:
>
> (1) the corporation files each report that is required by this chapter and that is delinquent;
> (2) the corporation pays the tax, penalty, and interest that is imposed by this chapter and that is due at the time the suit under Section 171.306 of this code to set aside forfeiture is filed; and
> (3) the forfeiture of the corporation's charter or certificate is set aside in a suit under Section 171.306 of this code.

Section 171.306 of the Tax Code provides:

> If a corporation's charter or certificate of authority is judicially forfeited under this chapter, a stockholder, director, or officer of the corporation at the time of the forfeiture of the charter or certificate or of the corporate privileges of the corporation may bring suit in a district court of Travis County in the name of the corporation to set aside the forfeiture of the charter or certificate. The suit must be in the nature of a bill of review. The secretary of state and attorney general must be made defendants in the suit.

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[99] TEX. TAX CODE § 171.256.

[100] TEX. TAX CODE § 171.302.

[101] TEX. TAX CODE § 171.303.