# CHOICE OF ENTITY OUTLINE

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This article is an outline of a lecture which we recently gave at a San Francisco tax conference. While to many of you the topic may seem old hat, we focused on the problems associated with using a limited partnership format with a limited liability entity such as an S corporation of an LLC as the general partner. We drilled into the allocation of debt rules under IRC 752 and the Anti-Avoidance rules applicable to tiered partnerships. Candidly, we don't believe that there is a more comprehensive analysis of these issues anywhere. The use of tiered limited partnership entities with limited liability entity as the general partner has become popular due to the costs associated with the use of LLC's in California. We think that this outline will serve as a useful guide for you.

## I. TYPES OF ENTITIES

A. Overview. The structure and operations of business entities can be varied by agreements, articles, bylaws and other formation documents to provide different rules for each business. For practical purposes, however, most business entities fall under one of the following categories:

B. Proprietorship. A sole proprietorship involves one owner (and his spouse) who owns, manages and controls the business. All profits and losses belong and are taxed to the business owner on Schedule C.

C. General Partnership ("GP"). A general partnership is a business entity in which two or more co-owners engage in business for profit. The partnership can hold and convey legal title to real property. It can sue and be sued. It is a separate entity for bankruptcy purposes. All general partners are liable for the debts of the partnership. It files a Form 1065 and the partners receive K-1s.

D. Limited Partnership ("LP"). A limited partnership is a partnership that has at least one general partner and one limited partner. The limited partner is not liable for any obligation of a limited partnership and, unless otherwise agreed, is at risk only to the extent of his or her contributed capital. The general partners are liable for partnership debts. (Form 1065 and K-1s)

E. Limited Liability Company ("LLC"). A limited liability company is a state chartered entity in which all owners have limited liability. (Form 1065 and K-1s)

F. Corporation. A corporation is a separate chartered entity existing under the authority of state law. It has its own separate identity separate and apart from the incorporator and shareholders. (Form 1120).

G. S Corporation ("S Corp"). An S Corporation is used to minimize "double" taxation from having a corporation. Generally, the S Corporation becomes a pass through entity; there is no federal or state tax at the corporate level, rather, the shareholders pick up their ratable share of income. (Form 1120S and K-1s)

## II. THE CHANGING RELATIONSHIP OF CORPORATE AND INDIVIDUAL FEDERAL INCOME TAX RATES

When a business is owned by individuals, a key factor in comparing the tax consequence of operating a business as a C corporation versus a "flow through entity" (S corporation or partnership) is the relationship of individual and corporate federal income tax rates. Effective in 2013, this relationship has changed with enactment of the American Taxpayer Relief Act of 2012. There are current discussions between Congress and President regarding a possible future reduction in the corporate tax rates.

A. The Past – 2102. In 2012 the federal income tax rate applicable to a corporation with taxable income between $335,000 and $10,000,000 was 34%. Corporations with taxable income in excess of $18,333,333 are subject to a 35% tax rate. During 2012, individuals were subject to a graduated progressive rate structure with rates ranging from 10% to 35%.

With the highest 2012 marginal tax rate for corporations and individuals being the same (35%), for large taxable income taxpayer situations; there was little or no current year increased tax cost associated with using a partnership or an S corporation in comparison to using a corporation not making the S corporation election.

Depending on the number of owners, the taxable income characteristics of the owners of the business, and the size of the business taxable income; there could be a slight advantage or disadvantage going either way for smaller taxable income situations. For example, if the business had taxable income of between $335,000 and $10,000,000 and all owners were subject to the marginal tax rate of 35%, there could be a 1% of taxable income cost of conducting the business as a partnership or making the S corporation election. Alternatively, if there were many owners all of whom were lower taxable income taxpayers (marginal tax rates not in excess of 28%) there could be a current year tax advantage from conducting the business using a partnership or S corporation.

In many 2012 situations the differences between individual and corporate rates were not significant, making the "cost" of using a partnership or S corporation comparatively small.

In 2013 individual rates increased without a corresponding increase in corporate tax rates.

B. The Current Year 2013. With the enactment of the American Taxpayer Relief Act of 2012, in 2013, individuals are subject to a graduated progressive rate structure with rates ranging from 10% to 39.6%. Corporate tax rates did not change in 2013. With the highest tax rate for corporations being 35% and individual highest marginal tax being 39.6%, for businesses with large taxable income taxpayers there is a potential 4.6% of taxable income increased tax cost associated with using a partnership or an S corporation in comparison a corporation not making the S corporation election.

Depending on the number and taxable income characteristics of the owners of the business and the size of the business taxable income, there could be a slight advantage or disadvantage going either way for smaller taxable income situations. For example, if the business had taxable income of between $335,000 and $10,000,000 and all owners were subject to a the highest taxable income marginal tax rate of 39.6%, there would be a 5.6% of taxable income cost of conducting the business as a partnership or making the S corporation election. Alternatively, if there were many owners all of whom were lower taxable income taxpayers (marginal tax rates not in excess of 28%) there could be a current year tax advantage from conducting the business using a partnership or S corporation.

In 2013 it is possible that there could be a significant tax cost (4.6% or 5.6% of taxable income) to conducting the business as partnership or S corporation rather than as a corporation not making the S election.

This change from 2012 could cause a reconsideration of whether it is desirable to conduct the business as an S corporation or a partnership.

C. The Future. There has been bi-partisan support for a reduction of the corporate tax rate. The corporate rates that have been proposed are 25% or 28%. If corporate rates were to be decreased but no change made to individual rates, the current year tax cost of conducting a business as partnership or S corporation could dramatically increase. If the highest tax rate for corporations is 28% and individual highest marginal tax rate for individuals is 39.6%, for the large taxable income taxpayers there is a potential 11.6% of taxable income increased tax cost associated with using a partnership or an S corporation in comparison to a corporation not making the S corporation election. Such a difference could cause a reconsideration of whether business should be conducted as a corporation without making the S corporation election.

In 2012, the relationship of corporate and individual rates was at a historical low as an important factor in the choice of entity decision. In 2013 this changed slightly. Based on current legislative discussions, these rate relationships could become more important in future years.

## III. STATE LAW – SALIENT CONSIDERATIONS IN ENTITY SELECTION

A. Limited Liability

1. Operating Losses/Failure of Business.

a. Most small businesses initially have operating losses and there is a high degree of risk the business may fail. Therefore, an owner will want an entity that protects his personal assets from business creditors, which results in three options: LLCs, corporations, or limited partnerships with a LLC or corporation as the general partner.

b. The owner will also want to take ordinary losses as opposed to capital losses from business operations or the failure of the business.

c. These two factors leave LLCs, S corporations or LPs with a corporation or LLC as the general partner as the entity choices.

2. LLC. Members of a LLC are generally protected from personal liability for business debts and claims. Corporations Code § 17101.

3. Corporation. Shareholders of a corporation are generally not personally liable for the debts of the corporation. *Wenban Estate, Inc. v. Hewlett* (1924) 193 Cal. 675, 696.

4. Limited Partnership with a LLC or Corporation as the General Partner. The Limited Partners are not personally liable for the debt obligations of the Limited Partnership. Corporations Code § 15903.03(a). The General Partner is personally liable for the debts of the Limited Partnership. Corporations Code § 15904.04. To achieve limited liability for all the owners, a LLC or corporation must be used as the general partner for the LP.

## IV. LIMITS ON LOSS ALLOWABILITY TO OWNERS OF ENTITY

A. Two Types of Losses. There are two types of possible losses for startups: operational and business failure.

B. Losses Limited to Basis in Equity. The allowability of losses for income tax purposes is limited to the owner's basis in the entity.

C. LLC. Under Section 704(d), a partner may deduct partnership operational losses allocated to him to the extent of his adjusted basis in his partnership interest. The partner's basis includes tax capital contributions and the partner's share of debt under IRC § 752.

D. Limited Partnership. Same as LLC.

E. S Corporation. A Shareholder of an S corporation may deduct losses of the corporation to the extent of the shareholder's basis in stock plus any amounts loaned to the corporation by the shareholder. IRC § 1366(d)(1).

1. S corporation shareholders do not get a share of the entity's debt for purposes of determining their basis in their stock, such as a partner can for the partnership's debt.

2. In order to take losses on debt by an S corporation, and thereby increase a shareholder's basis in indebtedness, there must be a shareholder loan and the loan must represent the S corporation's bona fide indebtedness. Prop. Reg. § 1.1366-2(a)(2)(iii), Example 2. S corporation shareholders generally are not permitted to increase their basis by guaranteeing a loan made by a third party to the corporation until they actually have to make payments on the guaranty. *Id.*; *Maloof v. Commissioner*, T.C. Memo 2005-75.

***Example #1:***

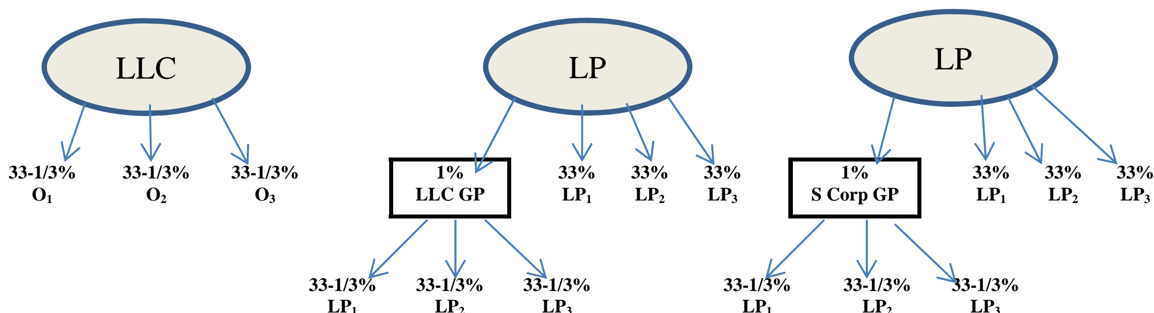
Shareholder's Basis with Shareholder Debt. In exchange for 100% of stock, A contributed $500,000 to form ABC, Inc., an S Corp. A also loaned $450,000 to ABC, Inc. A's stock basis is $500,000 and his debt basis is $450,000. In Year 1, ABC, Inc. has a loss of $750,000 at the end of the first year. A's stock basis is reduced to $0 and his debt basis is reduced to $200,000.

***Example #2:***

Shareholder's Basis with Third-Party Debt. In exchange for 100% of stock, A contributed $500,000 to form ABC, Inc., an S Corp. ABC, Inc. also borrowed $450,000 from a third-party which A guarantied. A's stock basis is $500,000 and his debt basis is $0. In Year 1, ABC, Inc. has a loss of $750,000 at the end of the first year. A's stock basis is reduced to $0. He cannot deduct any portion of the loss in excess of $500,000 because he has no debt basis.

F. Conclusion. If the entity is going to obtain third party debt (rather than owner loans), a LLC or LP with a LLC or S Corp will be the entity of choice structured as follows:

***Example #3:***



## V. REVIEW OF PARTNERSHIP DEBT ALLOCATION RULES

A. General Explanation—State Law. In order to understand the tax rules under Section 752, a basic understanding of the definition of recourse versus nonrecourse debt under State law is required.

1. Recourse debt is debt which does not restrict the creditor's ability to collect on the debt to the collateral securing the debt.

2. Nonrecourse debt is debt which restricts the ability of the creditor to collect against property secured by that debt. Debt can be made nonrecourse by specific contractual language contained in the debt instrument. There are also certain statutes which make debt nonrecourse even absent specific language. Some examples of these statutory restrictions are contained in the "anti-deficiency laws" of California.

3. Generally speaking, all debt is recourse unless the debt instruments state it is nonrecourse or unless there is an overriding state law. This is true whether it is secured by real property or personal property.

***Example #4:***

Recourse Debt under State Law to LLC. ABC, LLC is a limited liability company with A, B, and C as equal members. ABC, LLC has a $150,000 debt secured by a recourse mortgage on real property. The mortgage note does not contain any language to state that the loan is non-recourse. ABC, LLC subsequently defaults on the loan and the Bank judicially forecloses on the note but is only able to obtain $100,000 due to a downturn in the economy. This is a recourse loan under state law and the Bank is able to go after ABC, LLC's assets to obtain the remaining $50,000 on the debt.

***Example #5:***

Nonrecourse Debt under State Law to LLC. ABC, LLC is a limited liability company with A, B, and C as equal members. ABC, LLC has a $150,000 debt secured by a recourse mortgage on real property. The note contains language stating that the loan is non-recourse except for fraud, waste, etc. ABC, LLC subsequently defaults on the loan and the Bank judicially forecloses on the note but is only able to obtain $100,000 due to a downturn in the economy. This is a non-recourse loan under state law and the Bank cannot go after ABC, LLC's assets to obtain the remaining $50,000 on the debt.

B. What is a "Nonrecourse Liability" for Tax Purposes? Regulations Section 1.752-1(a)(2) provides that a partnership liability is treated as "nonrecourse" to the extent that no partner or related person bears the economic risk of loss ("EROL") for the liability.

C. What is a "Recourse Liability" for Tax Purposes? Regulations Section 1.752-1(a)(1) provides that a partnership liability is treated as a recourse liability to the extent that any partner or related person bears the EROL for the liability.

D. Tax Rule for Allocation of Recourse Debt.

**A PARTNER BEARS THE EROL FOR A PARTNERSHIP LIABILITY TO THE EXTENT THAT, IF THE PARTNERSHIP CONSTRUCTIVELY LIQUIDATED, THE PARTNER OR RELATED PERSON WOULD BE OBLIGATED TO MAKE A PAYMENT TO ANY PERSON (OR A CONTRIBUTION TO THE PARTNERSHIP) DUE TO THE FACT THAT THE LIABILITY BECOMES DUE AND PAYABLE AND THE PARTNER OR RELATED PERSON WOULD NOT BE ENTITLED TO REIMBURSEMENT FROM ANOTHER PARTNER OR A PERSON RELATED TO ANOTHER PARTNER.**

E. **CONSTRUCTIVE LIQUIDATION. THE FOLLOWING CIRCUMSTANCES CONSTITUTE A CONSTRUCTIVE LIQUIDATION FOR PURPOSES OF THE SECTION 752 REGULATIONS:**

1. **ALL OF THE PARTNERSHIP'S LIABILITIES BECOME PAYABLE IN FULL;**

2. **WITH THE EXCEPTION OF PROPERTY CONTRIBUTED TO SECURE A PARTNERSHIP LIABILITY, ALL OF THE PARTNERSHIP'S ASSETS, INCLUDING CASH, HAVE A VALUE OF ZERO;**

3. **THE PARTNERSHIP DISPOSES OF ALL OF ITS PROPERTY IN A FULLY TAXABLE TRANSACTION FOR NO CONSIDERATION (EXCEPT RELIEF FROM LIABILITIES FOR WHICH THE CREDITOR'S RIGHT TO REPAYMENT IS LIMITED SOLELY TO ONE OR MORE ASSETS OF THE PARTNERSHIP);**

4. **ALL ITEMS OF INCOME, GAIN, LOSS OR DEDUCTION ARE ALLOCATED AMONG THE PARTNERS; AND**

5. **THE PARTNERSHIP LIQUIDATES.**

***Example #6:***

AB, GP is a general partnership with A and B as equal partners. At formation, A and B each contributed $100,000 in cash. AB, GP purchases an office building on leased land for $1,000,000, paying $200,000 in cash and executing a recourse note to the bank for the balance of $800,000. AB, GP's partnership agreement provides that all items are allocated equally except that losses from depreciation or the sale of real property are specially allocated 90% to A and 10% to B and that capital accounts will be maintained in accordance with the regulations under Section 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation, the $800,000 liability becomes due and payable. All of AB, GP's assets, including the building, are deemed to be worthless. The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the hypothetical disposition, as follows:

| | A | B |
|---|---|---|
| Initial contribution | $100,000 | $100,000 |
| Loss on hypothetical sale | (900,000) | (100,000) |

| | | |
|---|---|---|
| | ($800,000) | $-0- |

Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership and the lender. Therefore, $800,000 of AB, GP's liability is classified as a recourse liability because one or more partners bear the EROL for nonpayment. B has no share of the $800,000 liability since the constructive liquidation produces no payment obligation for B. A's share of the partnership liability is $800,000 because A would have an obligation in that amount to make a contribution to AB, GP.

F. **PARTNER'S SHARE OF NONRECOURSE LIABILITIES FOR TAX PURPOSES.**

1. **IN GENERAL. A PARTNER'S SHARE OF PARTNERSHIP NONRECOURSE LIABILITIES INCLUDES THE FOLLOWING THREE TIERS:**

a. **THE PARTNER'S SHARE OF PARTNERSHIP "MINIMUM GAIN" DETERMINED IN ACCORDANCE WITH THE RULES OF SECTION 704(B) (TIER-1);**

b. **THE AMOUNT OF ANY TAXABLE GAIN THAT WOULD BE ALLOCATED TO THE PARTNER UNDER SECTION 704(C) IF THE PARTNERSHIP DISPOSED OF ALL PARTNERSHIP PROPERTY SUBJECT TO ONE OR MORE NONRECOURSE PARTNERSHIP LIABILITIES IN A TAXABLE TRANSACTION IN FULL SATISFACTION OF THE LIABILITIES AND FOR NO OTHER CONSIDERATION (TIER-2 §704(C) MINIMUM GAIN); AND**

c. **THE PARTNER'S SHARE OF EXCESS NONRECOURSE LIABILITIES (DEFINED AS NONRECOURSE LIABILITIES NOT ALLOCATED UNDER (A) OR (B) ABOVE) (TIER-3).**

2. Tier-1.

a. Coordinating Share of Nonrecourse Liabilities with Share of Minimum Gain. Partnership minimum gain is defined as the gain that a partnership would realize if it disposed of all partnership property subject to nonrecourse liabilities in full satisfaction of the liabilities, and for no other consideration. Minimum gain is a complicated concept under IRC §704. At this point, I want to give you a layman's explanation: the concept is that if a partner takes advantage of a deduction, such as depreciation, which is based on an allocation of nonrecourse debt, that partner must pay back that deduction when the property is sold.

***Example #7:***

AB, GP is a general partnership with A and B as equal partners. AB, GP buys property by paying $200,000 as a down payment and $800,000 as a nonrecourse note. The entire property is depreciable on a straight-line basis over 10 years with no residual value. In the

first and second year, there would be no "minimum gain" since no gain would be realized if the property were disposed of solely in consideration of the relief of the nonrecourse debt of $800,000. On the first day of year four (and ratably during year three), there would be minimum gain, because the basis of the property would be $700,000 and a disposition of the property for the relief of the $800,000 nonrecourse debt would produce $100,000 of "minimum gain." In tax parlance, there has been an "increase" in "minimum gain" of $100,000 from the beginning year three to the beginning of year four. Similarly, there has been $100,000 of "partnership nonrecourse deductions" for this period and A and B each have $50,000 of "partner nonrecourse deductions" for this period. Under Tier-1, both A and B would be allocated $50,000 of nonrecourse debt.

3. Tier-2: 704(c) Minimum Gain. A partner's share of partnership nonrecourse liabilities includes the amount of any taxable gain that would be allocated to the partner under Section 704(c) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration.

***Example #8*:**

AB, GP is a general partnership with A and B as equal partner. At formation, A transfers real property with a basis of $50,000 and a value of $100,000. B transfers $100,000 in cash. AB, GP takes out a nonrecourse loan secured by the property in the amount of $80,000. There is a total of $50,000 of built-in gain in the property contributed by A. A's Tier-2 allocation of the nonrecourse loan would be $30,000 ($80,000 - $50,000 = $30,000) because under §704(c), the $30,000 of §704(c) built-in gain in the real property will be allocated to A when it is sold solely in satisfaction of the nonrecourse debt of $80,000. There, A's share of §704(c) minimum gain is $30,000.

4. Tier-3. For Tier-3 allocations, the Regulations provide three principal alternative methods for determining a partner's share of excess nonrecourse liabilities. Excess nonrecourse liabilities are determined by subtracting the Tier-1 and Tier-2 allocated nonrecourse liabilities from the total nonrecourse liability. A partnership need not allocate excess nonrecourse liabilities under the same method each year. The three methods authorized under the Regulations are in proportion to: (i) profits; (ii) related deductions; or (iii) §704(c) gain.

***Example #9*:**

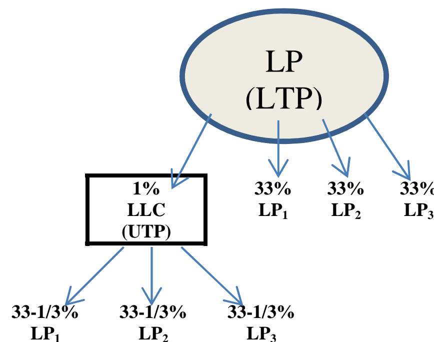
AB, GP is a general partnership with A and B as equal partners. At formation, A contributes $10,000 cash, and B contributes property with a value of $35,000, a basis of $10,000 and subject to a nonrecourse debt of $25,000. A and B agree they will use the traditional method to allocate Section 704(c) gain. Since a disposition of B's property for no consideration other than debt relief would generate $15,000 of gain under Section 704(c), $15,000 of the nonrecourse liability is allocated to B. The remaining $10,000 of the nonrecourse liability could be allocated between A and B in accordance with their interests in partnership profits – in this case $5,000 to each. In these circumstances, B is relieved of $25,000 of debt but also is allocated $20,000 of the partnership's liability. The

regulations allow these amounts to be netted, resulting in a net decrease in B's liabilities of $5,000. A's share of partnership liabilities is $5,000.

## VI. TIERED PARTNERSHIP SUBROGATION AND ANTI-ABUSE RULES.

A. Application of Recourse Liability Sharing Rules to Tiered Partnerships Where LLC is GP in a LP. The liabilities of a lower-tier partnership ("LTP") are allocated to an upper-tier partnership ("UTP") to the extent that the UTP and/or any of the partners in the UTP bear the EROL with respect to the liabilities. For purposes of this rule, a UTP is one which owns, directly or indirectly through one or more partnerships, an interest in another partnership. Generally, for purposes of applying Section 752 and the regulations thereunder to the partners of an upper-tier partnership, a UTP's share of an LTP's liabilities is treated as a liability of the upper-tier partnership. This rule does not apply, however, to LTP liabilities owed to the UTP.

***Example #10:***




Assume that LP 1, 2 and 3 contributed $25,000 each to LP as a capital contribution. Assume LLC contributed $1 as a capital contribution. Assume there is a $150,000 recourse debt incurred by LP. Under the tiered partnership rules, the portion of the debt allocated to the LLC under Section 752 will be a recourse debt to the LLC (assuming the Anti-Abuse Rules don't apply). Because this is a recourse debt, 100% would be allocated to the general partner LLC and because no owner of the LLC has personal liability, it would be treated as a nonrecourse debt at the LLC level and allocated accordingly.

B. Allocation of Recourse Debt Among More than One Partner. Generally, a liability can be taken into account only once for § 752 purposes. (Regs. §1.752-4(c)) In the context of tiered partnerships, this limitation prevents a person who is a partner in both a UTP and an LTP from including the same LTP liability in the bases of his interests in both the UTP and the LTP. In this type of situation, the liabilities apparently should be apportioned to the partner's respective bases in the two partnerships in proportion to the EROL that he bears as a partner of each partnership. A partner's EROL in the LTP should be

computed as if he were not a partner in the UTP. LTP liabilities should be allocated to his basis in the LTP to the extent of the resulting EROL. Then, his EROL should be computed for the UTP using the tier partnership rules. Any resulting indirect increase in his risk of loss for LTP liabilities over his EROL as a direct partner of the LTP should be allocated to his basis in the UTP.

***Example #11*:**

ABC, LP is a limited partnership with A, B, and C as limited partners and LLC (a limited liability company) as the 10% general partner. A owns a 20% limited partnership interest in LLC. ABC, LP owns property with a value of $200,000 that secures a $100,000 liability. A has guarantied all of this liability, but retains a right to reimbursement from LLC to the extent of $40,000. Despite the fact that A, as a member of LLC, has guarantied the debt, the allocation of ABC, LP debt is made as if A were not a member in LLC. A, in his capacity as limited partner of ABC, LP, is allocated the $60,000 of ABC, LP debt that he guarantied and for which he has no right to reimbursement. The remaining $40,000 of the liability is allocated to LLC as a result of its contribution obligation as general partner of ABC, LP. This is a nonrecourse debt at the LLC level. A's 20% share of this $40,000 liability then increases his basis in his LLC interest by $8,000 and not his basis in ABC, LP.

C. Rights of Subrogation Affecting EROL. Regulations Section 1.752-2(b)(5) provides a partner's or related person's obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner.

Under state law a limited partner who executes a guaranty normally has a right to reimbursement from the general partner to the extent the guaranty is paid. This right can be waived in writing. If the right is not waived, then the limited partner does not have EROL under the above cited regulation section. There are similar regulations under IRC Section 465.

***Example #12*:**

Effect of Subrogation Rights. ABC, LP is a limited partnership with A, B, and C as limited partners and LLC as the general partner. Each partner has a tax basis capital accounts of $25,000. ABC, LP borrows $150,000, secured by a recourse mortgage on real property. A, B and C guaranty the liability. If A, B and C have not waived their rights to subrogation, they will have the right to recover from LLC the amount paid to the lender. Therefore, A, B and C do not bear the EROL for the partnership liability and the debt is not allocated to them. Instead, the $150,000 is allocated to LLC. Therefore, this debt would be treated as nonrecourse debt at the LLC level but not the LP level and allocated to the members of the LLC accordingly (subject to the Anti-Abuse Rules, *infra*). If A, B and C waive their rights of subrogation, then they will have EROL as limited partners.

D. Is the Net Worth of the LLC GP Relevant to these Issues? Generally speaking, whether or not the general partner has or does not have a significant net worth is immaterial to the debt allocation

rules because the regulations presume that any allocated debt will be paid without regard to actual net worth. Reg. §1.752-2(b)(6).

E. Anti-Abuse Rules. There is an exception to the presumption that a partner can pay the debt allocated to it and this exception is commonly referred to as the "anti-abuse rule." Reg. Section 1.752-2(b)(6) states that the presumption that partners will pay their share of allocated debts does not apply if "the facts and circumstances indicate a plan to circumvent or avoid the obligation."

(a) Reg. Section 1.752-2(j) elaborates on this rule:

> (j) *Anti-Abuse rules. – (1) In general.* – an obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation to create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section.

(b) Reg. Section 1.752-2(j)(4) gives the following example:

***Example #13:***

Plan to Circumvent or Avoid Obligation. A and B form a general partnership. A, a corporation, contributes $20,000 and B contributes $80,000 to the partnership. A is obligated to restore any deficit in its partnership capital account. The partnership agreement allocates losses 20% to A and 80% to B until B's capital account is reduced to zero, after which all losses are allocated to A. The partnership purchases depreciable property for $250,000 using its $100,000 cash and a $150,000 recourse loan from a bank. B guaranties payment of the $150,000 loan to the extent the loan remains unpaid after the bank has exhausted its remedies against the partnership. A is a subsidiary, formed by a partner of a consolidated group, with capital limited to $20,000 to allow the consolidated group to enjoy the tax losses generated by the property while at the same time limiting its monetary exposure for such losses. These facts, when considered together with its guaranty, indicate a plan to circumvent or avoid A's obligation to contribute to the partnership. The rules of section 753 must be applied as if A's obligation to contribute did not exist. Accordingly, the $150,000 liability is a recourse liability that is allocated entirely to B.

(c) The example given above includes an element of tax motivation in concluding that A's obligation to contribute money to satisfy the debt should be disregarded. In examining the Anti-Abuse Rules, McKee mentions "tax motivation" as a factor:

> The scope of this anti-abuse rule seems to embrace situations in which (1) it appears that, *primarily* for tax avoidance purposes, one or more

partners have undertaken a contribution or payment obligation that will not, or cannot practically, be enforced, and (2) if such obligation were not enforced, other partners would have payment or contribution obligations that would be enforced. In addition, the anti-abuse rule may apply in situations where the partners attempt to have debt that is substantively nonrecourse treated as recourse debt. (McKee, Federal Taxation of Partnerships and Partners Section 8.02(5).)

(d) Whether or not a tax motivation is required to apply the Anti-Abuse Rules can be quite important because often the creation of limited liability structures such as a limited partnership with a corporate or limited liability company general partner are not tax motivated, but rather are either required by the lender in order to have a bankruptcy remote entity or are designed to minimize exposure to third party claims. The author submits that the presence or absence of a tax motivation is not essential to the application of the Anti-Abuse Rules as both of the above-cited regulations define the test as whether the "principal purpose" is to eliminate that partner's economic risk of loss with respect to that obligation. Using a shell corporation or shell limited liability company as the general partner is specifically designed to make a loan a "nonrecourse loan" with respect to the individual limited partners even though, on the face of the loan, it appears to be recourse.

***Example #14***:

Assume A and B, individuals, desire to form an entity to buy real property. The lender requires a bankruptcy remote entity and a limited partnership with a 1% corporate general partner is used. The corporation is owned equally by A and B. A and B also own all the limited partnership interests. The loan is a recourse loan but there are no personal guaranties. How is the loan allocated? 100% to the general partner? 1% to the general partner and 99% to the limited partners?

Assuming the above analysis to be correct, then the debt would be treated as a "nonrecourse loan" as no partner would bear the economic risk of loss with respect to that loan under the Anti-Abuse Rules. The loan would then be allocated among the partners under the rules relating to nonrecourse debts, i.e., 1% to the corporate general partner and 99% to A and B as limited partners.

## VII. CONCLUSIONS ABOUT SELECTION OF ENTITY AS A RESULT OF DEBT ALLOCATION RULES AND LIMITED LIABILITY CONCERNS

A. Recourse Debt to LLC Not Guarantied by Members. While a recourse debt (which is not guarantied by anyone) to a LLC is "recourse" for state law purposes, it is nonrecourse debt for tax purposes and normally will be allocated in proportion to the members' percentage interests (subject to 3-tier analysis). The members can take deductions equal to the sum of tax capital and allocable debt.

***Example #15:***

ABC, LLC is a limited liability company with A, B, and C as equal members each with tax basis capital accounts of $25,000. ABC, LLC borrows $150,000, secured by a recourse mortgage on real property. A, B and C do not guaranty payment of the loan. The mortgage liability is treated as a nonrecourse liability of ABC, LLC and $50,000 is allocated to A, B and C each. Therefore, A, B and C can each take deductions/losses up to $75,000 each (subject to the Anti-Abuse Rules).

B. Recourse Debt to LLC Guarantied by Members. A recourse debt to a LLC that is Guarantied by some of the members (who waive subrogation rights) is allocated equally to the guaranteeing members as recourse debt.

***Example #16:***

ABC, LLC is a limited liability company with A, B, and C as equal members each with tax basis capital accounts of $25,000. ABC, LLC borrows $150,000, secured by a recourse mortgage on real property. A and B guaranty payment of the loan but C does not. The mortgage liability is treated as a recourse liability to A and B and the $150,000 is allocated to A and B equally. Therefore, A and B can each take deductions/losses up to $100,000 but C is limited to $25,000.

C. Nonrecourse Debt to LLC. A debt which is nonrecourse to the LLC by its terms is allocated to the members in accordance with their percentage interests (subject to 3-Tier analysis). The members can take deductions equal to the sum of tax capital and allocable debt.

***Example #17:***

ABC, LLC is a limited liability company with A, B, and C as equal members each with tax basis capital accounts of $25,000. ABC, LLC borrows $150,000, secured by a nonrecourse mortgage on real property. A, B and C do not guaranty payment of the loan. The mortgage liability is a nonrecourse liability of ABC, LLC and the $150,000 is allocated to A, B and C equally. Therefore, A, B and C can each take deductions/losses up to $75,000 each.

D. Recourse Debt to LP with S Corp as GP Not Guarantied. If there is an S Corp as the general partner of a LP with recourse debt which is not guarantied, the S Corp will be allocated all of the debt and nothing will be allocated to the limited partner to support deductions for them (subject to the Anti-Abuse Rules, *infra*). Therefore, S Corps are generally not recommended to act as a general partner for a LP with non-guarantied recourse debt.

***Example #18:***

ABC, LP is a limited partnership with A, B, and C as limited partners and Inc. (an S Corp) as the general partner. Each partner has a tax basis capital accounts of $25,000. A, B, and C are equal shareholders in Inc. ABC, LP borrows $150,000, secured by a recourse mortgage on real property. A, B, and C do not guaranty this note. The $150,000 debt is allocated to Inc. as general partner but none of the debt can be passed through to

A, B, or C as shareholders of Inc. since they did not lend money to ABC. The total losses are limited to the capital contributions of $25,000 each.

E. Recourse Debt to LP with S Corp as GP Guarantied by LPs.

***Example #19:***

ABC, LP is a limited partnership with A, B, and C as limited partners and Inc. (an S Corp) as the general partner. Each limited partner has a tax basis capital accounts of $25,000. A, B, and C are equal shareholders in Inc. ABC, LP borrows $150,000, secured by a recourse mortgage on real property. A and B have guarantied this note but C has not. The debt is allocated as recourse to Inc. as general partner and A and B as guarantors. However, if A and B have the right of subrogation against Inc., then A and B have no EROL. Accordingly, the $150,000 debt would be allocated as recourse to Inc. but none of the debt would be passed through to A, B or C as shareholders of Inc. since they did not lend money to ABC. In order for A and B to receive an allocation of debt, they would have to waive their subrogation rights against Inc. (subject to the Anti-Abuse Rules, *infra*). Even if A, B and C guarantied the debt of $150,000 and waived the right of subrogation, they would not have any debt basis in the S corporation but they would be entitled to a portion of the debt basis shared with the S corporation because they would have EROL under the partnership

F. Nonrecourse Debt to LP with S Corp as GP and No Guaranties.

***Example #20:***

ABC, LP is a limited partnership with A, B, and C as limited partners and Inc. (an S Corp) as the general partner. Each partner has a tax basis capital accounts of $25,000. A, B, and C are equal shareholders in Inc. ABC, LP borrows $150,000, secured by a nonrecourse mortgage on real property. A, B and C have not guarantied this note. The debt is allocated among Inc. and A, B and C in accordance with their percentage interests (subject to 3-tier analysis). None of the debt allocated to Inc. can be passed through to A, B, and C as shareholders of Inc. since they did not lend money to Inc.

G. Recourse Debt to LP with LLC as the GP and No Guaranties. Under IRC §752, since the GP is liable for the recourse debt of the LP, it is allocated to the LLC as the general partner. Because no member of the LLC or limited partner of the LP guarantied the debt, the debt will be nonrecourse to the LLC and the members of the general partner LLC will receive an allocation of debt as determined under the 3-tier test. Accordingly, usually the LLC which is the general partner should be owned in the same proportions as the LP (subject to Anti-Abuse Rules).

***Example #21:***

ABC, LP is a limited partnership with A, B, and C as limited partners and LLC as the general partner. Each partner has a tax basis capital accounts of $25,000. LLC is solely owned by D. ABC, LP borrows $150,000, secured by a recourse mortgage on real property. A, B, C, and D do not guaranty this debt. As the general partner, the lender has recourse to LLC so it bears the EROL and the $150,000 is allocated to it. None of the debt is allocated to A, B, or C because of their limited partner status. At the upper-tier

partnership level, the debt is treated as a nonrecourse debt since none of its members are personally liable, so D is allocated the $150,000 as nonrecourse debt (subject to the Anti-Abuse Rules).

H. Recourse Debt to LP with LLC as GP and Guaranties by Members of LLC.

***Example #22:***

ABC, LP is a limited partnership with A, B, and C as limited partners and LLC as the general partner. Each limited partner has a tax basis capital account of $25,000. LLC is solely owned by D. ABC, LP borrows $150,000, secured by a recourse mortgage on real property. D guaranties the loan. Again, the lender has recourse to LLC as the general partner. Again, none of the debt is allocated to A, B or C since they are limited partners. At the upper-tier partnership level, LLC treats it as a recourse debt because D has guarantied it and the $150,000 debt is allocated to D as recourse debt.

I. Recourse Debt to LP with LLC as GP and with Guaranties by LPs.

***Example #23:***

LPs Guaranty Debt. ABC, LP is a limited partnership with A, B, and C as limited partners and LLC as the general partner. Each partner has a tax basis capital accounts of $25,000. LLC is solely owned by D. ABC, LP borrows $150,000, secured by a recourse mortgage on real property. A and B guaranty this loan but C does not. The loan is recourse against LLC as general partner, and A and B as guarantors. However, A and B have the right of subrogation against LLC, which means they have no EROL so no debt is actually allocated to them. Instead, it is allocated as recourse debt to LLC. At the upper-tier partnership level, LLC treats the debt as nonrecourse since D has no personal liability, so D is allocated $150,000 nonrecourse debt. If A and B have waived subrogation rights, then A, B and LLC would all have EROL which would have to be allocated between them.

## VIII. ABANDONMENT AND WORTHLESS WRITE OFFS FOR CORPS AND LLCS OR LPS

A. Section 165—General Rule. IRC Section 165(a) allows a deduction for any loss attributable to a business or a for-profit activity sustained during the taxable year and not compensated for by insurance or otherwise. The amount of the deduction for a loss is the taxpayer's adjusted basis as provided in IRC section 1011.

1. Closed and Completed Transaction Requirement. Regs. Section 1.165-1(b) and (d) provide that, to be allowable as a deduction under IRC Section 165(a), a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event and actually sustained during the taxable year. While traditionally, the closed and completed transaction is a evidenced by a sale, transfer, foreclosure, deed in lieu of foreclosure, or some similar identifiable action, interpretations of Code section 165(a) and its Regulations demonstrate that full divestiture of possession or title is not a prerequisite to

sustaining a section 165(a) loss. (Echols v. Commissioner, 935 F.2d 703, reh'g denied, 950 F.2d 209 (5th Cir. 1991), rev'g, 93 TC 553 (1989).

2. Character: Because abandonment and worthlessness losses can occur without the taxpayer receiving anything in exchange for the loss, abandonment/worthlessness provide an opportunity to sustain an ordinary loss on what might otherwise be considered a capital asset.

B. Abandonment of Partnership Interest. To establish the abandonment of an asset for purposes of IRC Section 165, a taxpayer must show both (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. (*A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); *CRST, Inc. v. Commissioner,* 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990); Rev. Rul. 93-80, 1993-2 C.B. 239.)

C. Character of Loss. Whether a loss from the abandonment of a partnership interest is capital or ordinary depends on whether the loss results from the "sale or exchange" of a capital asset. (IRC § 165(f); *and see* Rev. Rul. 93-80.) Accordingly, if the partner receives anything in exchange for his abandoned partnership interest (generally in the form of a 752 distribution), the loss is subject to being treated as a capital loss.

1. Deemed Distribution. Under Code section 752, a partner receives a deemed distribution from the partnership to the extent that he is no longer bears the EROL for partnership debts. Even a de minimis distribution or deemed distribution will characterize the entire loss as capital. (Rev. Rul. 93-80.)

a. Recourse Debt. Because a partner will remain liable for his share of partnership recourse debt even after the abandonment or worthlessness of a partnership interest, the existence of recourse debt (absent any partnership nonrecourse debt) generally will not be subject the partner to capital loss treatment. (*See* Rev. Rul. 93-80, Situation 1.)

b. Nonrecourse Debt. Conversely, a partner will be relieved of his obligation with respect to partnership nonrecourse debt upon the abandonment of his partnership interest, and therefore an abandonment in such a situation will subject a partner to capital loss treatment. (*See* Rev. Rul. 93-80, Situation 2.) (Distinguish worthless partnership interest, below.)

D. Worthlessness of a Partnership Interest.

1. General. A loss based on worthlessness is deductible in a year that the Taxpayer can and does properly deem the property worthless to him, provided the worthlessness is demonstrable by closed and completed transaction evidenced through fixed and identifiable events. Worthlessness

requires (1) objective facts demonstrating the property's worthlessness; and (2) taxpayer's subjective determination that the property is worthless to him.

2. Worthless Partnership Interest with Nonrecourse Debt. An abandoned partnership interest generally means that the partner will no longer bear EROL for partnership debt and thus will have a deemed distribution under section 752. As discussed above, this requires the section 165(a) loss to be capital rather than ordinary. But the facts of Rev. Rul. 93-80 only contained a partner abandoning his partnership interest, and in the context of a worthless partnership interest, the partner will generally still be bound by the partnership agreement. Because of this fact, the partner's basis will still be allocated a share of partnership nonrecourse debt. The IRS has not provided any definite guidance on this but one position is to exclude nonrecourse debt allocation but retain the ordinary character since the partner will continue to bear the EROL. However, be aware that since the nonrecourse debt allocation would continue, it suggests that the transaction is not closed and completed.

E. Abandonment and Worthless Interests in S or C Corps. Generally, these events result in a capital gain or loss under IRC §165(g).

## IX. PAYROLL TAX DIFFERENCES BETWEEN CORP AND LLC OR LP (ASSUMING TRADE OR BUSINESS OPERATIONS)

A. Review S Corp. Employment taxes often have been the deciding factor in choosing between an "S" corporation and a LLC. With an "S" corporation, only the salary paid to the employee-owner is subject to employment taxes but not the undistributed taxable income. (Rev. Rul. 59-221). The salary paid, however, must be reasonable. The IRS has held that when shareholders perform services for an "S" corporation but don't draw a salary, any "dividends" paid to the shareholders in lieu of reasonable compensation for these services are treated as wages subject to withholding. (Rev. Rul. 74-44).

B. Partnerships. Generally, partners must pay self-employment taxes on their share of the ordinary income of the partnership, as well as any guarantied payment received. IRC §1402(a). A "limited partner" is not required to pay self-employment tax on their share of the ordinary income of the partnership except for guarantied payments received for services. IRC §1402(a)(13).

C. Recent Case Law. In 2011, the Tax Court concluded that the status as a limited partner does not necessarily exempt a partner from self-employment taxes; the exemption depends on the partner's level of participation in partnership business. *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011); *See also Howell v. Commissioner*, T.C. Memo 2012-303.

D. Proposed Regulations. Proposed regulations released in 1997 apply to any entity classified as a partnership for federal tax purposes, regardless of the state-law characterization of the entity as a LP or LLC. Under the proposed regulations, a partner will be treated as a limited partner unless he (1) has personal liability for the partnership's debts; (2) has authority to contract on behalf of the partnership under state law; or (3) participates in the partnership's trade or business for more than 500 hours per year. Prop. Regs. §1.1402(a)-2(h)(2). Additionally, an individual who is a service partner in a service partnership may not be a limited partner. Prop. Regs. §1.1402(a)-2(h)(5).

1. Exceptions. The proposed regulations provide two exceptions.

*a. More than One Class of Interests. The first would apply to holders of more than one class of interest. Prop. Regs. 1.1402(a)-2(h)(3). Under this exception, if an individual has rights and obligations with respect to a specific class of partnership interest that are identical to those of limited partners owning a substantial (i.e., at least 20%) and continuing interest in that class, the individual would be treated as a limited partner for that class. In other words, general partners in limited partnerships who also own limited partnership interests may be able to escape self-employment tax on their distributive share of partnership income from the limited partnership interest.*

***Example #24:***

GP and LP Interest. ABC, LP is a limited partnership with A owning 1% as general partner, and A, B, and C each owning 33% as limited partners. A receives a salary of $50,000 for his services as general partner and at the end of the year ABC, LP has $100,000 in distributive income. A's $50,000 salary and distributive share of $1,000 as general partner would be subject to self-employment tax. However, A's distributive share of $33,000 as a LP would not be subject to self-employment tax since A's LP interest is identical to B and C who have at least 20% LP interest.

*b. More than 500 Hours. The second exception would apply to holders of one class of interest who are not treated as limited partners solely because they participate in the partnership's trade or business for more than 500 hours. Prop. Regs. 1.1402(a)-2(h)(4). Under this exception, such an individual is treated as a limited partner if the individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by limited partners owning a substantial (i.e., at least 20%), continuing interest in that class.*

***Example #25:***

ABC, LP is a limited partnership with A owning 1% as general partner, and A, B, and C each owning 33% as limited partners. B receives a guarantied payment of $50,000 for 600 hours of services rendered to ABC, LP, and at the end of the year ABC, LP has $100,000 in distributive income. B's income of $50,000 is subject to self-employment tax because it's a guarantied payment but his distributive share of $33,000 is not subject to

self-employment tax his disqualification as a limited partner is solely because he participated in ABC, LP for more than 500 hours and his right and obligations are identical to those of A and C as LPs.

E. C Corporation. As a separate taxable entity, the C corporation must withhold payroll taxes from all employees' salaries, including shareholder-employees. The C corporation will then match the amounts withheld (only this portion of the FICA taxes forwarded to the IRS is deductible by the corporation). Any shareholder who also works for the corporation is treated the same as other employees. There are no self-employment tax issues for a C corporation, since the corporation is a separate legal entity.

## X. NEW MEDICARE AND NET INVESTMENT INCOME (NII) TAX

A. New Taxes. Starting in 2013 there is an increased tax on wages and investment income that are part of the Affordable Care Act.

1. Additional Medicare Tax on Wages and Self-Employment Income. The Medicare tax rate is increased from 2.9 percent to 3.8 percent for wages and self-employment income in excess of: i) $250,000 for married filing jointly; ii) $200,000 for single taxpayers; and iii) $125,000 for married filing separately.

***Example #26:***

Medicare Tax. A, a single taxpayer, earns wages of $300,000 in 2013. On $100,000 of wages A will pay an extra 0.9% Medicare tax, or $900.

2. The Net Investment Income Tax (NIIT). High-income individuals will pay an extra 3.8% tax on the lesser of NII or the modified adjusted gross income (MAGI) in excess of i) $250,000 for married filing jointly; ii) $200,000 for single taxpayers; and iii) $125,000 for married filing separately.

a. NII Categories. NII consists of three categories of income: (1) gross income from interest, dividends, annuities, royalties, and rents that are nonbusiness income (investment or personal), passive business income, or the business of trading in financial instruments or commodities; (2) other gross income from a passive business or a business of trading in financial instruments or commodities; and (3) net gain on the disposition of property, that is, except net gain attributable to nonpassive, nontrading business property.

b. MAGI Defined. MAGI is the adjusted gross income (AGI) plus any foreign earned income excluded under IRC §911(a), less any deductions or exclusions disallowed under

§911(d)(6) related to foreign earned income. In short, if you have no foreign earned income, then your AGI equals your MAGI.

***Example #27:***

NIIT. A, a married taxpayer, earns wages of $225,000, dividends of $30,000, and interest of $40,000, for an adjusted gross income of $295,000. In addition to his regular income tax obligation, A must pay an additional 3.8% tax on the lesser of NII of $70,000 (interest and dividends), or excess AGI of $45,000 ($295,000 - $250,000). In this case, A will pay an additional 3.8% on $45,000, i.e., $1,710.

B. Passive Activities. All income from a LLC, S Corp, or sole proprietorship is NII if the trade or business is passive to the taxpayer or it is in the trade or business of trading in financial instruments.

C. Not Passive Activities. If a taxpayer owns a sole proprietorship, a single-member LLC, or an interest in a partnership or S corporation, any income or gain generated from the activity will not be NII if the activity is engaged in an active trade or business that is not the trading of financial instruments, the income is derived from the ordinary course of that trade or business, and the activity is not a passive activity to the taxpayer under §469 (i.e., materially participates).

1. Grouping. Any elections made to group activities under §469 are respected for purposes of determining if a trade or business is passive under NII.

***Example #28:***

ABC, Inc. is an S corporation with equal ownership by A, B, and C. ABC, Inc. is engaged in a trade or business that does not involve trading in financial instruments. A works 2,000 hours during 2013. B and C do not work any hours in 2013. ABC, Inc. earns $300,000 in income in the ordinary course of its trade or business and $30,000 of interest and dividend income. A has materially participated in ABC, Inc. so he has $100,000 of ordinary income. B and C have not materially participated so they each have $100,000 of NII. Additionally, A, B, and C must include their share of the dividends and interest in their NII.

D. LLC and S Corp Owners Who Materially Participate. Keep in mind that while owners who materially participate in a LLC or S Corp are generally not subject to the NIIT on their share of the entity's income, they may be subject to Medicare tax on income that is deemed to be wages over the threshold amount (i.e., $250,000 for MFJ; $200,000 for single taxpayers; $125,000 for MFS).

## XI. BUILT-IN GAIN AND BUILT-IN LOSS RULES FOR S CORPS, LLCS AND LIMITED PARTNERSHIPS

A. Partnerships or LLCs.

1. Built-in Gains. Any built-in gain inherent in property at the time of its contribution to a partnership or at the time of its revaluation must be allocated to the Contributing Partner (or partners whose capital accounts are increased in the revaluation) when the built-in gain is recognized. IRC §704(c).

2. Built-in Losses. If contributed property has a built-in loss, then (1) the built-in loss is to be taken into account only in determining the amount of items allocated to the contributing partner, and (2) in determining the amount of items allocated to other partners, the partnership's basis in the contributed property is treated as being the fair market value of the property at the time of contribution. IRC § 704(c)(1)(C).

B. S Corp. A sale of assets by an S corporation that used to be a C corporation during the "recognition period" is subject to a built-in-gains tax. A built-in-gain tax is imposed on the corporation, at the highest corporate tax rate, on the appreciation in asset value that existed on the date the corporation became an S corporation. The shareholders may then be subject to a second tax on distribution of the sales proceeds. This double tax created by imposition of the built-in gain rules can be eliminated if the corporation holds and sells assets only after the recognition period has expired. Generally, the recognition period is 10 years but through 2013 it is 5 years. IRC §1374(d)(7). That means you can sell assets in 2013 that you have held at least 5 years without triggering built-in gains tax under IRC §1374.

***Example #29:***

Asset Sale in 2013. ABC, Inc. was incorporated as a C Corporation. ABC, Inc. timely filed an election to be treated as an S Corporation as of 1/1/08. On the date of conversion, ABC, Inc. had land with a cost basis of $150,000 and a Fair Market Value of $550,000. In April 2013, ABC, Inc. sold the land for $700,000. There is no built-in-gain on the sale of the land because the property was sold after the 5-year recognition period ended on 12/31/12, so ABC, Inc. recognizes a capital gain of $550,000.

***Example #30:***

Asset Sale in 2014. Asset Sale in 2014. ABC, Inc. was incorporated as a C Corporation. ABC, Inc. timely filed an election to be treated as an S Corporation as of 1/1/08. On the date of conversion, ABC, Inc. had land with a cost basis of $150,000 and a Fair Market Value of $550,000. In April 2013, ABC, Inc. sold the land for $700,000. There is no built-in-gain on the sale of the land because the property was sold after the 5-year recognition period ended on 12/31/12, so ABC, Inc. recognizes a capital gain of $550,000.

## XII. TAX IMPACTS OF CONVERTING FROM A CORPORATION TO A LLC OR FROM A LLC TO A CORPORATION

A. Conversion of Corporation to LLC. Converting a C corporation to a LLC taxed as a partnership often results in a large tax bill because there is double taxation. While there may be exceptional circumstances that will substantially reduce the taxes involved in this type of conversion, such as the corporation having no built-in gain or appreciation of assets, or having significant net operating losses ("NOLs") that can offset gains on its distribution of assets during liquidation, in many cases the taxes will outweigh any potential advantages of conversion.

B. Conversion of LLC to Corporation. The LLC contributes all of its assets and liabilities to a newly formed corporation in exchange for its stock. A deemed distribution of the stock is then made to the members in complete liquidation of the LLC. Under Internal Revenue Code Section 351, the deemed contribution of assets and liabilities to the corporation is considered a tax-free contribution, and therefore the transaction itself generally results in no gain/loss. However, a LLC may be taxed if the aggregate liabilities assumed by the new corporation exceed the aggregate tax basis of the assets contributed.

## XIII. LLC TAX VS. S CORP TAX

A. LLC Tax. Limited partnerships, corporations, S corporations and LLCs must all pay the annual minimum franchise tax of $800. However, the LLC is also subject to an additional "fee" that was included in the original legislation that authorized the formation of LLCs in California. Revenue and Taxation Code Section 17942(a) imposes a fee that is determined by an entity's "total income," basically its gross revenues. Under this Section, the amount of the fee is determined as follows:

1. $0 for LLCs with annual gross revenues of less than $250,000;
2. $900 for LLCs with annual gross revenues of at least $250,000 but less than $500,000;
3. $2,500 for LLCs with annual gross revenues of at least $500,000 but less than $1,000,000;
4. $6,000 for LLCs with annual gross revenues of at least $1,000,000 but less than $5,000,000;
5. $11,790 for LLCs with annual gross revenues of $5,000,000 or more.

B. Constitutionality. The fee based on gross receipts has been struck down as an unconstitutional tax, and is no longer computed based on worldwide gross receipts. The fee is now computed on gross receipts sourced to California using sourcing rules which are used to source gross receipts for the numerator of the sales factor.

1. *NES, LLC v. FTB*, 71 Cal. Rptr. 3rd 642 (Cal. Ct. App. 2008). NES was a Washington-organized LLC that did not have any business activity in California but had registered with the California secretary of state. NES did not pay the Gross Receipts fee and later sought to cancel its registration with the state. The Franchise Tax Board (FTB) notified NES that outstanding fees for prior years, plus interest and penalties, were due, and the FTB issued an assessment for $27,458.13. NES paid the assessment to obtain a California Tax Clearance Certificate (which was required in order to dissolve) and filed a claim for refund of the LLC fees, penalties, and interest paid. The Superior Court ruled in favor of NES and the Court of Appeal upheld that ruling and determined that the fee assessed under CA Rev. and Tax. Code §17942 violated the Commerce Clause of the U.S. Constitution and that NES was entitled to a full refund.

2. *Ventas Finance I, LLC v. FTB*, 165 Cal. App. 4th 1207 (2008). A Delaware LLC with income within and outside of California challenged the constitutionality of California's LLC fee. A California Court of Appeal held that California's LLC fee was unconstitutional because the statute did not provide a method of fair apportionment for calculating the total income used to determine the LLC fee. As a result of the ruling, LLCs that earned income in California and elsewhere were due a refund of the difference between the total amount paid and the amount that would have been due if the fee had been fairly apportioned based on California activity.

3. *Bakersfield Mall, LLC v. FTB*, San Francisco Superior Court Case No. CGC07462728. FTB was granted a Petition to Coordinate this case with *CA-Centerside II, LLC v. FTB*, Fresno Superior Court Case No. 10CECG00434. These cases involve LLCs that do business solely in California and they challenge the constitutionality of the fee. These cases are still ongoing.

C. Fee Based on Revenue Regardless of Profit. Realistically, the amount of the fee is relatively small. At $250,000 in gross revenues the fee is 0.36% of revenues; at $500,000 it is 0.5% of revenues; at $1,000,000 it is 0.6% of revenues; and at $5,000,000 it is 0.2358% of revenues. However, the fee is assessed against gross revenues, so the fee is due notwithstanding profitability. For a business with high revenues but narrow profit margins, the fee would reflect a higher portion of the entity's profitability than it would on a business that is highly profitable. Obviously, the fee would be particularly irritating for those entities that anticipate incurring losses in their early stages of development.

D. Examples. A small restaurant may have gross receipts of $1.5 million and net income of $250,000. The restaurant must pay a fee of $6,000 based on its gross receipts instead of $900 if the fee was based on net income.

This additional fee can be mitigated by using a limited partnership with a LLC as general partner with identical ownership among each entity. Having twin entities with identical ownership may adversely impact the ability to avoid piercing the corporate veil.

1. S Corp Tax. S Corps that are doing business in California must pay a 1.5% net income tax at the entity level with a minimum of $800.

2. Comparison of Gross Receipts Tax vs. S Corp Tax. These numbers assume a 20% net profit margin but does not include the $800 franchise tax for LLCs.

| Net Income | Gross Sales | LLC Tax | S Corp Tax |
|---|---|---|---|
| $40,000 | $200,000 | $0 | $800* |
| $70,000 | $350,000 | $900 | $1,050 |
| $140,000 | $700,000 | $2,500 | $2,100 |
| $400,000 | $2,000,000 | $6,000 | $6,000 |
| $1,200,000 | $6,000,000 | $11,790 | $18,000 |

## XIV. RULES RELATING TO PIERCING THE VEIL

A. When Courts will Pierce the Veil.

1. There is no real separation between the company and its owners, called the Alter Ego Theory.

a. To establish alter ego, a creditor must show that two conditions are met: First, there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder (or other corporate entity) do not in reality exist. Second, there must be an inequitable result if the acts in question are treated as those of the corporation alone. (See *F. Hoffman-La Roche v. Superior Court*, 130 Cal. App. 4th 782, 796 (2005).)

2. The company's actions were wrongful or fraudulent.

3. The company's creditors suffered an unjust cost.

B. Factors Considered in Piercing the Veil.

1. Whether the company engaged in fraudulent behavior.

2. Whether the company failed to follow corporate formalities.

3. Whether the company was inadequately capitalized.

C. LLCs. California is somewhat unique in that it has codified the standard in the LLC statutes. That statute imposes personal liability on a member of a LLC to the same extent as a shareholder of a corporation, except that where meetings of members or managers are not required, the failure to observe formalities regarding the calling or conduct of those meetings is not a factor to be considered in establishing that liability. Cal. Corp. Code Section 17101(b). In this regard, a LLC may be a better choice of entity it does not have to worry about keeping corporate minutes to avoid piercing the veil.

D. Reverse Piercing on LLCs Not Allowed. Additionally, LLCs offer charging order protection from "reverse piercing," which is an effort on the part of a personal creditor of a LLC member to reach the LLC's assets to satisfy the member's debt to the judgment creditor, while corporations do not offer this protection to their shareholders. Consequently, a creditor of an owner can directly reach the owner's shares in a corporation, but not the owner's LLC membership interest.

## XV. STATE LAW LIMITATIONS ON USING LLCS

A. Professional Services Cannot Use LLC. Under California law, providers of "professional services" cannot legally form a LLC. Corporations Code §17375. "Professional services" means any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code, the Chiropractic Act, the Osteopathic Act, or the Yacht and Ship Brokers Act. Corporations Code §§13401, 13401.3.

1. Common professionals include the following:
   a. Accountants
   b. Acupuncturists
   c. Architects
   d. Chiropractors
   e. Doctors
   f. Dentists
   g. General Contractors
   h. Lawyers
   i. Marriage and Family Therapists
   j. Nurses
   k. Optometrists
   l. Pharmacists
   m. Psychologists

n. Physical Therapists

o. Physician Assistants

p. Securities Brokers

q. Veterinarians

r. Attorneys and accountants may form limited liability partnerships, i.e., LLPs, to limit individual owner liability for other partners' malpractice to the lesser of $500,000 or $100,000 multiplied by the number of partners.

B. LLC May Not Engage In Certain Activities. The LLC may not engage in the banking business, the business of issuing policies of insurance and assuming insurance risks, or the trust company business. Corp. Code 17002.

## XVI. NEW CALIFORNIA LLC LAW

A. RULLCA. In January 2014, the existing limited liability company act in California (the Beverly-Killea Limited Liability Company Act) will be repealed and superseded by the California Revised Uniform Limited Liability Company Act, popularly known as RULLCA. RULLCA gets its basis from the Uniform Limited Liability Company Act, which was promoted by the National Conference of Commissioners on Uniform State Laws (NCCUSL), and has many similarities to the Beverly-Killea Act; however, RULLCA contains significant differences from both. RULLCA differs from the Uniform Limited Liability Company Act in the areas of preserving dissenter's rights and prohibiting professional LLCs. Additionally, RULLCA was designed to improve upon presumed failings of the Beverly-Killea Act.

B. Effective for Transactions After January 1, 2014. RULLCA will take effect January 1, 2014 so it will govern only those actions, transactions, and contracts entered into by the LLC or its members or managers on or after that date. The Beverly-Killea Act will remain governing actions, transactions, and contracts made before January 1, 2014.

C. Freedom of Contract. RULLCA gives a maximum effect to the principles of freedom of contract and to the enforceability of operating agreements, but it will nonetheless alter provisions of an existing operating agreement.

D. Articles of Incorporation and Operating Agreement Must Both Establish Managers. RULLCA authorizes manager-managed LLCs, but it requires that a company's articles of organization and operating agreement expressly establish management by a manager or managers. If an existing LLC is relying on such a statement solely in its articles of organization, its operating agreement must be

revised to provide that the company is manager-managed, or else it will be subject to RULLCA's default rule and become a member-managed entity.

E. Activities Requiring Unanimous Member Consent. RULLCA provides certain rules for manager-managed LLCs, including a requirement that the consent of all members of a LLC is required to do any of the following:

1. Sell, lease, exchange, or otherwise dispose of all, or substantially all, of the LLC's property, with or without the goodwill, outside of the ordinary course of the LLC's activities;

2. Approve a merger or conversion under RULLCA;

3. Undertake any other act outside the ordinary course of the LLC's activities; or

4. Amend the operating agreement.

5. These provisions may only be varied by a written operating agreement. Thus, prior to January 2014, managers of a California LLC should review and amend any operating agreement to ensure that it expressly identifies when the consent of all members is required and when it is not, including specifically addressing those matters which would otherwise be subject to the revised RULLCA rules.

6. There are a number of other conceptual changes under RULLCA that affect both manager-managed and member-managed LLCs alike. Some of the more prominent changes include the following:

a. Operating Agreements. Operating agreements may now be implied as well as written or oral.

b. Conflicts. One function of RULLCA is to give a company's operating agreement priority over its articles of organization in the event of conflicting provisions. The only exception is for third parties reasonably relying on the articles. Any existing LLC that has been relying on a statement in its articles (e.g., that a LLC is manager-managed) must amend its operating agreement prior to January 2014 to eliminate the conflicting provision, or be subject to the change.

c. Fiduciary Duties. RULLCA's focus on fiduciary duties has been a much discussed topic of the new Act. RULLCA expands the concept of governing fiduciary duties to explicitly include the duty of loyalty, the duty of care, and "any other fiduciary duty." While RULLCA prohibits an operating agreement from "unreasonably reducing the duty of care," it will allow companies to modify (but not eliminate) the duty of loyalty as it applies to a manager. However, any such modification must be clearly stated in a company's operating agreement with the informed consent of the members. RULLCA emphasizes the heightened knowledge required in such situations, and notes that informed

consent by a member differs from a member who is deemed to statutorily assent to the operating agreement when such party becomes a member of a LLC. Any existing LLC that opts to modify the fiduciary standards imposed by RULLCA should consider what actions are necessary to obtain the appropriate consent from its members.

d. Indemnification. RULLCA's default rules provide for mandatory indemnification of any member in a member-managed LLC and any manager of a manager-managed LLC who complies with the duties set forth in the Act. However, RULLCA provides that an operating agreement may alter or eliminate such indemnification and may limit or eliminate completely a member or manager's liability to the LLC and other members for money damages, except with respect to: breaches of the duty of loyalty; receipt by such party of a financial benefit to which such party was not entitled; liability for excess distributions; intentional inflictions of harm (on a person or the LLC); or intentional violations of criminal law. An existing LLC should consider the benefits and liabilities of the proposed RULLCA indemnification policies and, to the extent possible, amend its operating agreement to address any concerns.

e. Overriding RULLCA Provisions. As noted above, RULLCA contemplates giving the maximum effect to the enforceability of operating agreements. However, the new Act identifies certain provisions from which a LLC cannot "opt-out" in its operating agreement. Thus, mangers, members and their advisors may need to contemplate whether a California LLC still satisfies the needs of the entity under the new law.

F. Administrative Costs.

1. Limited Partnership with a LLC. One practical problem with having a Limited Partnership with a LLC as a general partner is the additional administrative complexity and costs of two returns, two sets of books, and the complexity of providing the governance documents and explaining the structure to third parties such as lenders, title companies, etc. This also provides a level of complexity when the Limited Partnership is involved in sales or purchases. So, in order to use this type of entity structure you need to have sufficient "economies of scale" to warrant its use.

## XVII. SINGLE MEMBER ENTITIES

A. Corporation or LLC. Since a partnership must have at least two people to be formed, the only options for a single member entity are either a corporation or LLC.

B. Single Member LLCs. From a formation standpoint, a significant LLC development in California was the adoption of single member LLCs. This change eliminated the requirement of having owners as members to initially form a California LLC.

C. Single Member LLC Must Elect to be Taxed as Corporation. A LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it files Form 8832 and affirmatively elects to be treated as a corporation.

D. Single Member LLCs Generally Use Owners SSN. For federal income tax purposes, a single-member LLC classified as a disregarded entity generally must use the owner's social security number (SSN) or employer identification number (EIN) for all information returns and reporting related to income tax. For example, if a disregarded entity LLC that is owned by an individual is required to provide a Form W-9, Request for Taxpayer Identification Number and Certification, the W-9 should provide the owner's SSN or EIN, not the LLC's EIN.

E. Employment and Excise Taxes Require an EIN. However, for certain Employment Tax and Excise Tax requirements, the EIN of the LLC must be used instead. Therefore, a LLC will need an EIN if it has any employees or if it will be required to file certain excise tax forms. Thus, most new single-member LLCs classified as disregarded entities will need to obtain an EIN.

F. Single Member LLC May Obtain an EIN Even if It's Not Required. A single-member LLC that is a disregarded entity that does not have employees and does not have an excise tax liability does not need an EIN. It should use the name and TIN of the single member owner for federal tax purposes. However, if a single-member LLC, whose taxable income and loss will be reported by the single member owner, nevertheless needs an EIN to open a bank account or if state tax law requires the single-member LLC to have a federal EIN, then the LLC can apply for and obtain an EIN.

G. Husband and Wife. Since the introduction of single member LLCs, there has been confusion as to whether a husband and wife who owned the entire interest of a LLC as community property qualify a single member. In order to provide some guidance in this area, the IRS adopted Revenue Procedure 2002-69. This procedure applies to an entity if: (1) the entity is wholly owned by a husband and wife as community property under the laws of a state, foreign country, or possession of the United States; (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) the entity is not treated as a corporation under IRS Regulation Section 301.7702-2. In these situations, the IRS will respect the husband and wife's treatment of the entity as either a disregarded entity or partnership for federal tax purposes. However, the IRS will treat any change in the reporting

position by the husband and wife as a conversion of the entity. California has also adopted Revenue Procedure 2002-69, so a husband and wife entity in California who own their LLC membership as community property are classified as a single member LLC and is a disregarded entity for tax purposes.