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Limited Liability Companies: The Entity of Choice*

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Introduction

Limited Liability Companies ("LLCs") are now the entity of choice for closely-held operating businesses in most jurisdictions. Every state and the District of Columbia have enacted LLC statutes. LLCs are preferred over corporations and general partnerships, and even over limited partnerships, because LLCs enjoy the full flowthrough income taxation of partnerships, yet offer limited liability for all of their owners. Those income tax rules are quite different than traditional corporate concepts, and the creditor protection qualities make LLCs as safe to own as corporations.

All LLC participants enjoy limited liability for the acts and debts of the business, making them superior to general partnerships in which all partners have unlimited liability, and often more desirable than limited partnerships in which general partners still have unlimited liability.

LLCs are superior to C corporations because C corporation earnings are subject to two levels of tax—the corporate level and the shareholder level. The flow-through taxation of LLCs eliminates the double tax difficulties attendant to using C corporations. Since LLCs are taxed as partnerships, taxable earnings are passed through to the owners, and are taxed only one time.

Moreover, stock in a C corporation has an essentially static basis. LLCs maintain capital accounts for the owners in conformity with regulations under IRC §704(b). The capital account keeps track of the owners' investments in the LLC, and is increased by the annual profits of the company allocated to each owner and decreased by each owner's share of the company's annual losses.

LLCs are also more flexible than S corporations. There are no limitations on the types and numbers of shareholders. There is no "one class of stock" rule, and owners of an LLC increase basis in their LLC interests for proportionate amounts of the LLC's debt (which is much more difficult to achieve in an S corporation). Moreover, special allocations available to an LLC can create highly customized equity interests, interests that are definitely not possible under the one class of stock rule.

LLCs are much easier to form and maintain than corporations. There is no 80% control test to avoid income recognition on transfers of appreciated assets to the LLC in exchange for an ownership interest. In addition, there can be a bifurcation of interests between capital interests and profit sharing interests. This distinction makes it much easier to bring new owners into an existing business without income tax complications.

Another advantage of LLCs over both S and C corporations is the ability to withdraw assets, other than cash and "hot assets," without immediate recognition of income, even when appreciated assets are distributed.

Another huge difference is that the LLC is not treated as a separate entity, but rather is treated principally under the aggregate theory. The result is that there are no concerns about dividends (constructive or declared). In short, the corporation as a separate entity is no longer a constant source of concern.

The Check-the-Box Regulations

The "check-the-box" regulations gave LLCs a major impetus. Prior to these regulations, there was significant concern that LLCs would be taxed as corporations. Under the "check-the-box" regulations, there no longer is a danger of this result unless the LLC affirmatively elects to be taxed as a corporation. An LLC can even have unlimited life and still be taxed as a partnership.

The default treatment of a one-person LLC is to be disregarded and treated as a sole proprietorship. The default treatment of an LLC with more than a single participant is to be taxed as a partnership.

Buy-Sell Planning For LLCs is Different

Two significant differences pervade buy-sell planning for LLCs. The first is the insider basis adjustment under IRC §754(b) and the second is the transfer for value rule exclusion for partners.

In the corporate cross purchase context, the buyer's cost

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becomes his basis in the shares if he owned no other shares of stock. If the purchaser already owns stock in the corporation, then the buyer's cost is added to the purchaser's prior basis to determine the purchaser's aggregate basis in all of his stock. However, in the corporate setting, there is no change in the cost basis of the company's assets, which remains the same.

The results differ significantly in an LLC cross purchase. The seller may only receive capital gain treatment for a portion of the interest being sold. Furthermore, the purchaser may be able to cause the company to adjust the cost basis of its assets. The value of the interest being acquired will reflect the current value of the company's assets. If the value of the assets exceeds their adjusted cost basis (the "inside basis"), then the purchaser can request an adjustment of the company's books and records to change the cost basis of the LLC's assets to current market value. The entire cost basis of each asset will not be changed; only the percentage equal to the portion of the company being acquired by the purchaser will be adjusted.

This "inside basis adjustment" can only be made only if an "IRC §754 election" is made by the tax matters member of the LLC. Once made, it applies to all future IRC §754-type transactions.

The right to require the LLC to make an IRC §754 election can be a negotiated provision in a buy-sell agreement, and the purchaser may make the §754 election a condition of the sale. In addition, a purchaser should evaluate the company's assets prior to making the acquisition if a §754 election already is in effect, since there can be a downward basis adjustment if assets have declined in value.

When there is a purchase, the capital account of the seller is transferred to the purchaser. Further, when a §754 election is in effect, the capital accounts of all of the members are adjusted to reflect the fair market value of assets in accordance with their respective profit sharing allocations. Receiving an appropriate adjustment of the capital account is important, because an operating agreement may not have substantial economic effect if liquidation of the company and distributions of income and capital do not take positive and negative capital accounts into account when allocating taxable income or calculating distributions of capital.

A liquidation of an owner's interest in an LLC is also treated differently from a stock redemption (its functional equivalent in the corporate setting). With a C corporation, the company redeems the shareholder's stock. If the redemption of stock qualifies as a complete termination of the owner's interest in the company (other than as a creditor), then the redemption receives exchange treatment. In family situations, the selling shareholder seeks to avoid application of the attribution rules of IRC§ 318, which can prevent exchange treatment. Moreover, the transaction will not receive exchange treatment if it is deemed a bailout of corporate earnings. If these significant hurdles are overcome, then the entire purchase price will be deemed a capital transaction, with the seller recognizing a capital gain or loss. The same is true of an S corporation stock redemption when the redemption is treated as a complete termination of the owner's interest in the company.

Payments to an LLC owner in liquidation of his interest in the company are treated as capital transactions and receive sale or exchange treatment under IRC §736(b). Any gain is a capital gain.

Actual recognition of gain is deferred until the payee receives cash or sells property received in the liquidation. Marketable securities are deemed to be cash. There are none of the complex rules that one encounters with corporate redemptions, determining whether a redemption is a sale or exchange or a dividend. In an extended payout in a liquidation, the gain is not recognized until all the owner's cost basis in the entity is recovered. This can result in more favorable results than regular installment reporting of income. If there is a loss on the liquidation, the loss is not recognized until the final liquidating payment is made.

However, there can be ordinary income tax implications of a liquidation, too. Under IRC §736(a), payments made in liquidation that are deemed to be guaranteed payments or a distributive share of future LLC income are taxed as ordinary income. Payments for the owner's share of unrealized receivables are treated as §736(a) payments. If paid to an estate on account of a liquidation of a deceased member's interest in the LLC, then the payments are IRD. As IRD, the value of the ordinary items do not receive the step up in basis under IRC §1014.

In a liquidation, the LLC can make an election to adjust the basis of capital assets in an amount equal to the capital gain that the retiring owner has to or will recognize in the future on the liquidation if an IRC §754 election is in effect. Alternatively, if an IRC §754 election previously was made and the seller will recognize a loss, then the LLC has to make a negative adjustment to the basis of its capital assets on its books and records. The LLC will be able to amortize stated goodwill in the liquidation.

When an insured-owner dies, the death benefit is received by the policy owner and beneficiary income tax free, and is used to pay for the deceased owner's interest in the company. Where there is more than one LLC owner, there may be a transfer of an interest in the policies on the remaining owners' lives, but there is no transfer for value since all of the insureds are partners in a partnership with the insured under IRC §101(a)(2)(B).

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Particularly in the context of unrelated owners, there is a constant search for security in the buy-sell arrangement. Put simply, the owners often do not trust each other to carry out the terms of the agreement, resulting, they fear, in costly litigation and delay in getting the funds necessary for their families' welfare to them. Also, in the context of a cross-purchase arrangement, the plethora of policies required even where there are just a few owners creates administrative burdens. The result is sometimes consideration of a buy-sell agreement wherein a trustee holds the life insurance policies and is charged with seeing to the application of the death benefits to the obligations under the buy-sell agreement. This is called a "trusteed buy-sell agreement."

A significant difficulty with the trusteed buy-sell agreement is that each time a death occurs, there is a transfer of an interest in the remaining policies among the survivors. It seems likely that this transfer occurs in consideration of the parties' mutual promises and therefore constitutes a transfer for value, making all or at least part of the death benefit taxable as ordinary income. This problem is entirely solved by the fact that the LLC owners are all treated as a partners in a partnership for transfer for value purposes.

Conclusions

It seems clear for all of the forgoing reasons that the LLC is now the entity of choice for operating businesses.

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