JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

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DO YOUR CLIENTS' LLCs NEED FIXING?

PART III – FIVE COMMON MISTAKES IN FORMING MULTI-MEMBER LLCS

INTRODUCTION

There are currently about 24,000 New Hampshire LLCs (as compared with about 25,000 corporations). About half of these LLCs have only a single member; most of the rest have two members, and a handful have three or more members. A substantial majority of New Hampshire LLCs, both single- and multi-member, are formed by their founders without the help of accountants or lawyers; and very often, they are formed incorrectly. You can often do a favor for your LLC clients if you tactfully point out to them their LLC formation mistakes and suggest how to fix them.

In the June 2004 issue of this newsletter, I listed and briefly described all of the 13 main mistakes that LLC members often make in forming LLCs (including both single-member and multi-member LLCs). In the July issue, I discussed in some detail the first eight of these mistakes – namely, the eight mistakes that people typically make in forming *single*-member LLCs; and I explained how to fix these mistakes. In this issue, I'll discuss the five main mistakes that occur in forming multi-member LLCs and what you can do to fix this latter set of mistakes.

MISTAKE #1 – FAILURE TO STRUCTURE YOUR LLC TO MINIMIZE SOCIAL SECURITY TAXES

Under the governing IRS authority – namely, Prop. Reg. §1.1402(a)-2 (the "Rev. Proc.") – all of the members of a multi-member LLC taxable as a partnership must pay Social Security taxes on their shares of LLC income even if they perform no services for the LLC. The members of non-professional LLCs can avoid Social Security taxes if their LLCs have two classes of members and meet certain other Rev. Proc. rules.

One of the most common mistakes made by people who form LLCs without consulting tax professionals is to incur needless Social Security taxes by incorrectly structuring their LLCs. These people need to talk to a tax professional who understands the Rev. Proc. and knows how to apply it in LLC agreements.

MISTAKE #2 – FAILURE TO STRUCTURE YOUR LLC TO AVOID PARTNERSHIP FEDERAL INCOME TAX PROBLEMS

As most readers will know, under the IRS's famous "Check-the-Box" regulations, the default federal income taxation of LLCs with two or more members is partnership taxation under Internal Revenue Code Subchapter K. For simple LLCs in which all member contributions are cash and the financial arrangements among the members are simple, the members probably won't ever have significant partnership tax problems. However, Subchapter K is complex and contains a lot of pitfalls even for relatively uncomplicated LLCs. Here are two of the biggest Subchapter K pitfalls:

- <u>IRC Section 704(c)(1)(A) – the precontribution gain rule</u>. John and Mary form JM, LLC, a two-member LLC, and they agree that they will share profits and losses equally. John contributes raw land to JM with a basis of $100,000 and a fair market value of $1 million. Mary contributes $1 million in cash, which the LLC spends to develop the land. They sell the developed land for $4 million. They assume that they will share the proceeds of the sale equally. However, when the IRS audits JM, John learns to his dismay that under the "precontribution gain rule" of IRC Section 704(c)(1)(A), the first $900,000 of JM's gain is taxable exclusively to him as the "built-in gain" in his contribution. So, while John and Mary share the cash from the sale equally, John takes the brunt of the tax hit.

- <u>Liquidation in accordance with capital accounts</u>. In forming JM, John and Mary draft their own LLC agreement, and the agreement doesn't contain a provision requiring that all liquidating distributions be in accordance with capital accounts. The IRS performs a random preliminary audit of JM. When the agent notices the absence of capital accounts provisions, he becomes suspicious and greatly ratchets up the intensity of the audit. In the end, JM emerges with no tax deficiencies; but handling the audit imposes a heavy financial and psychological burden on John and Mary.

Obviously, what John and Mary should have done before they formed JM was to see a tax professional with a solid basic knowledge of Subchapter K. If they had done so, they might have paid a few dollars in professional fees, but they could have saved a world of aggravation.

MISTAKE #3 – FAILURE TO ADDRESS INTEREST AND DIVIDEND (I&D) TAX ISSUES

The I&D Tax applies (with certain narrow exceptions) to LLC members who reside in New Hampshire and whose LLCs have "transferable shares." It is all too easy for people who form LLCs to create a needless liability for the I&D Tax for themselves by agreeing among themselves in their LLC agreements to rights of first offer, rights of first refusal and other cash-out arrangements whose purpose is to give them liquidity. If these people talk to tax professionals who are familiar with the I&D Tax statute and regs, they can easily provide themselves with as much liquidity as they want in their LLC agreement but also avoid this I&D Tax trap.

MISTAKE # 4 – FAILURE TO MAKE S ELECTION

As mentioned above, Prop. Reg. §1.1402(a)-2 can provide an effective means of protecting passive members of multi-member LLCs from Social Security taxes on their shares of LLC income. However, the Rev. Proc. only works for *non-professional* LLCs, and even for these LLCs, it only works if, among other things, one or more passive members account for at least 20% of all contributions. The only way that professional multi-member LLCs and non-professional LLCs who flunk the 20% test can protect their members from Social Security taxes is to make an S election. If your clients own a professional LLC (i.e., one whose members are accountants, architects, actuaries, attorneys, consultants, engineers or health professionals) or a non-professional LLC with little or no passive investment, you may be able to save your clients a lot of Social Security taxes by having them make an S election for their LLC.

MISTAKE # 5 – FAILURE TO ADOPT A WRITTEN LLC AGREEMENT

In my experience, the founders of as many as three quarters of all multi-member LLCs formed in New Hampshire never enter into a written agreement among themselves about their LLCs. This means that, whether they like it or not, they are stuck with the "default" rules of the New Hampshire Limited Liability Company Act (the "LLC Act") – i.e., the rules of the Act that apply unless you change them in writing. Some of these default rules work just fine for most LLCs; but some of them may lead to disaster.

For example, one default rule of the LLC Act provides, in effect, that all members of an LLC get one vote on each LLC matter, regardless of the amount of their contribution. Thus, if Tom contributes $500,000 to an LLC and Mary and Jane each contribute only $50,000, Mary and Jane can nevertheless outvote Tom and dominate the LLC.

There is only one way for the members of a multi-member LLC to avoid LLC Act default rules that don't work for them; they have to enter into a written LLC agreement that alters these rules. (Under the LLC Act, oral agreements aren't valid.) If the financial stakes of a multi-member LLC aren't high, it may not be cost-effective to hire an LLC lawyer to write the agreement, but it will probably at least be worthwhile for the members to find a good form somewhere and do the agreement themselves. But if the stakes are substantial, the members should bite the bullet and hire professionals to help them.