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TAX AND LEGAL PLANNING WHEN THE OWNER OF A SINGLE-MEMBER LLC TAXABLE AS A DISREGARDED ENTITY WANTS TO ADMIT A SECOND MEMBER

EXECUTIVE SUMMARY. Before the member of a New Hampshire single-member LLC that is taxable as a disregarded entity for federal income tax purposes admits a second member to the LLC, the current member and the prospective member should undertake careful federal income tax planning and should carefully negotiate the terms of an LLC agreement between them. If they do not, they may face serious tax pitfalls under Rev. Rul. 99-5 and serious legal pitfalls under the New Hampshire Limited Liability Company Act (the "New Hampshire LLC Act").

The present issue of this newsletter provides an overview concerning the relevant federal income tax issues in converting single-member LLCs to two-member LLCs. The next issue will discuss the relevant legal issues in these conversions.

DISCUSSION

I. INTRODUCTION

There are presently about 32,000 New Hampshire LLCs. By extrapolating from Internal Revenue Service filing statistics, we know that about one-half of these LLCs are single-member LLCs. We also know that most of these single-member LLCs are classified for federal income tax purposes as "disregarded entities." Every year the owners of a significant portion of these single-member LLCs—at a minimum several hundred of them and perhaps a thousand or more—admit one or more additional persons as co-members. The key points of which New Hampshire CPAs and lawyers should be aware in assisting current and prospective members of these LLCs in converting them from single-member to two-member LLCs are briefly discussed below.

In the discussion that follows, I will refer to the original member of such an LLC as "A" and the prospective new member as "B." In addition, the discussion below will address only conversions of a single-member LLC to a two-member LLC in transactions in which, immediately after the conversion, the members will be equal. However, the principles set forth in the discussion will apply also to conversions of single-member LLCs to LLCs with three or more members and to conversions that do not result in equality among the members.

In this discussion, I will assume that the assets of the LLC in question (the "LLC") consist exclusively of capital assets and Section 1231 assets (*i.e.*, in essence, depreciable property and real estate held for more than one year for use in a trade or business); that the current aggregate fair market value of these assets is $1,000,000; and that A's adjusted tax basis in the assets is $500,000.

II. FEDERAL INCOME TAX ISSUES--OVERVIEW

1) The two methods for converting a single-member LLC to a two-member LLC. Under Rev. Rul. 99-5 (the "Ruling"), there are two methods by which B can become an equal member of the LLC:

   a) Method 1. B can pay A $500,000 for one-half of the LLC's assets. A and B will then be deemed to contribute their respect shares of these assets to the LLC, which will be deemed to become a partnership under Internal Revenue Code Subchapter K and the default rules of the U.S. Treasury Department entity classification rules usually referred to as the "Check-the-Box Regulations."

   b) Method 2. A can cause the LLC to issue B a one-half interest in itself in exchange for B's contribution of $1 million to the LLC.[1]

2) Exhibit A; principal federal income tax differences under Methods 1 and 2. The principal holdings of the Ruling as applicable to Methods 1 and 2 (referred to in the Ruling as "Situation 1" and "Situation 2") are briefly summarized in the attached Exhibit A. However, the most obvious differences between Methods 1 and 2 are these:

   i) Under Method 1, B must invest only $500,000 in the LLC in order to obtain a one-half interest in it. Under Method 2, B must invest $1 million.

   ii) However, under Method 1, A will probably have to recognize gain. Under Method 2, A will not have to recognize gain.

3) Other differences. In addition, as shown in Exhibit A, each of the two methods will result in very different adjusted tax bases for A and B in their respective membership interests in the LLC and in very different bases and holding periods for the LLC in the contributed assets.

4) Impact of the tax situations of A and B and of their plans for the LLC. Finally, the specific federal income tax situations of A and B and their plans for the LLC may importantly affect their planning as to how to structure the conversion. For example, this planning may be importantly affected:

   a) If A has significant unused long-term capital gains; or

   b) If there is little tax depreciation in the relevant assets.

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[1] Obviously, if, as required by Method 2, A will be contributing $1 million in assets to the LLC and if B is to be an equal member of the LLC, B, must contribute $1 million in cash to the LLC under Method 2 and not the $500,000 that B paid under Method 1 for a one-half interest in A's assets.

5) Need for tax planning. In short, as indicated above, whenever (a) a single-member LLC classified as a disregarded entity holds non-cash assets or (b) either party will contribute non-cash assets to it in connection with its conversion to a two-member LLC, careful federal income tax planning should be done before the conversion.

EXHIBIT A

SUMMARY OF HYPOTHETICAL FACTS AND RULINGS IN INTERNAL REVENUE SERVICE REV. RUL. 99-5

1) Facts: A is an individual who owns a single-member LLC (the "LLC") that owns various assets, all of which are either capital assets or Section 1231 assets. The total fair market value of these assets is $10,000.[2]

2) Situation 1. B, who is unrelated to A, purchases one-half of A's ownership interest in the LLC for $5,000. A and B then proceed to operate the LLC as equal owners.

3) Situation 2. B, who is unrelated to A, contributes $10,000 to the LLC, and the LLC issues B a one-half interest in the LLC. A and B then proceed to operate the LLC as equal owners.

4) Relevant Internal Revenue Code provisions.

   a) Section 721(a): In general, no gain or loss is recognized to a partnership or to any partner in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

   b) Section 722: The basis of an interest in a partnership that is acquired by a partner by contributing property, including money, to the partnership is the amount of the money and the adjusted basis of the property at the time of the contribution.

   c) Section 723: The basis of property contributed to a partnership by a partner is the adjusted basis of the property in the hands of the contributing partner at the time of the contribution.

   d) Section 1001(a): Gain or loss from sale or other disposition of property is the difference between the amount realized and the adjusted basis under Section 1011.

   e) Section 1223(1): In general, in determining the holding period of a taxpayer who receives property in an exchange, there shall be included the period for which the taxpayer held the property exchanged.

   f) Section 1223(22): In determining the holding period of a taxpayer who holds property, there shall be included the period for which such property was held by any other person if the property has the same basis in whole or in part in the taxpayer's hands as it would have in the hands of such other person.

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[2] Section 1231 assets are (i) depreciable assets and (ii) real estate used in a trade or business and held for more than one year. If the combined gains and losses from the taxable dispositions of section 1231 assets is a gain, such gains are treated as long-term capital gains. In arriving at section 1231 gains, however, the depreciation recapture provisions (for example, sections 1245 and 1250) are first applied to produce ordinary income. If the net result of the combination is a loss, such gains and losses for section 1231 assets are treated as ordinary.

5) Federal income tax results in Situation 1.

   a) When B purchases his interest, the LLC becomes a partnership.

   b) B's purchase is treated as a purchase by B of 50% of each of A's assets, which are treated as held directly by A immediately before the purchase.

   c) Immediately after the above deemed purchase, A and B are treated as contributing their respective interests in the above assets to a partnership in exchange for ownership interests in the partnership.

   d) Under Section 1001, A recognizes gain from the deemed sale of his 50% interest in each of the above assets to B.

   e) Under Section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the LLC from a disregarded entity to a partnership.

   f) Under Section 722:

      i) A's basis in his partnership interest is equal to A's basis in his 50% share of the assets of the LLC.

      ii) B's basis in his partnership interest is $5,000 (the amount he paid to A for the assets which B is deemed to contribute to the newly-created partnership).

   g) Under Section 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.[3]

   h) Under Section 1223(1):

      i) A's holding period in his partnership interest includes his holding period in the capital assets and Section 1231 property held by the LLC when it converted to a partnership.

      ii) B's holding period for his partnership interest begins on the day after the date of B's purchase of the LLC from A. (*See* Rev. Rul. 66-7, 1966-1 C.B. 188.)[4]

   i) Under Section 1223(2), the partnership's holding period for the assets transferred to it includes A's and B's holding periods for these assets.

6) Federal income tax results in Situation 2.

   a) A is treated as contributing all of the assets of the LLC in exchange for a partnership interest.

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[3] It is unclear to me which each individual asset of the new partnership has a split basis or whether, instead, bases may be assigned among the assets on an aggregate basis by pro rata fair market value of each asset at the time of the partnership's formation.

[4] It appears that in Situation 2, the holding period of the partnership in each of its assets will be a split holding period. This can greatly complicate partnership accounting upon, for example, the sale of a partnership asset.

b) B's contribution of cash to the LLC is treated as a contribution to a partnership in exchange for a partnership interest.

c) Under Section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

d) Under Section 722, B's basis in the partnership is equal to $10,000 (the amount of cash he has contributed to the partnership).

e) Under Section 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands.

f) Under Section 1223(1), A's holding period for his partnership interest includes his holding period in the capital assets and Section 1231 assets he is deemed to have contributed to the partnership.

g) B's holding period in his partnership interest begins on the day following his contribution of $10,000 to the partnership.

h) Under Section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

i) In Situation 2, the assets deemed to be contributed by A are not deemed to have a split basis or a split holding period.

j) However, in Situation 2, Section 704(c)(1)(A) (the "precontribution gain rule") will apply to A. Thus, if the partnership disposes of these assets, gain or loss will be recognized to A, and any depreciation in the assets must be recognized to B. This will result in complex accounting for the partnership.