

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

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**THE TOP TEN LLC
FEDERAL TAX AUTHORITIES**

EXECUTIVE SUMMARY. There are many hundreds of federal tax authorities potentially critical to tax accountants and lawyers in handling federal tax issues for their LLC clients. These authorities take the form of, among other things, Internal Revenue Code provisions; decisions by the Tax Court and other federal courts; U.S. Treasury Department temporary and final regulations; Internal Revenue Service proposed regulations; and IRS revenue procedures, revenue rulings and private letter rulings. And of course the list of these LLC federal tax authorities is constantly growing.

However, in my experience, the most important of these authorities are the 10 individual authorities and closely related pairs of authorities listed and briefly described below. In my view, every accountant and lawyer who handles LLC federal tax matters should have at least a general familiarity with each of these authorities.

Several of the authorities in the list below are discussed in detail in previous issues of this newsletter that are archived under the "LLC Newsletter Archives" button on the left-hand side of the home page of my website. You can visit this website at www.llcformations.com. In future issues, I intend to address all such authorities that I have not yet addressed.

DISCUSSION—THE TOP TEN LLC FEDERAL TAX AUTHORITIES

- 1) The "Check-the-Box" Regulations. These regulations (technically known as the "Entity Classification Regulations," and codified as U.S. Treas. Regs. Sections 301.7701-1 through 4) contain comprehensive rules determining the federal tax regimens potentially available to U.S. and foreign entities and providing rules for elections of these regimens by "eligible entities."
- 2) The four principal Internal Revenue Code federal income tax regimens. Depending on the relevant facts, the Check-the-Box Regulations permit single-member and multi-member LLCs to be subject to federal tax treatment under any one of the four major federal tax regimens. These regimes are, of course:
 - The set of rules in the Internal Revenue Code governing the federal income taxation of individuals; and
 - Federal income taxation under IRC Subchapter C, Subchapter K (partnership taxation) and Subchapter S.

It is true that the tax items of most single-member LLCs are subject to federal tax treatment under the rules governing individuals and that the tax items of most multi-member LLCs are subject to federal tax treatment as partnerships. However, many

single-member and multi-member LLCs are (or should be) taxable as S corporations; and a very few are (or should be) taxable as C corporations.

Thus, in order to be well equipped to handle LLC federal tax matters, tax accountants and lawyers must have a solid basic understanding of all four regimens and the regulations and other federal tax authorities that interpret and apply them.

- 3) Liability of LLC members for Social Security Taxes on their shares of LLC income. For many individuals who are members of LLCs (including both single-member and multi-member LLCs), the avoidance of Social Security Tax on their shares of LLC income is an important federal tax issue. In general, if these individuals are members of single-member LLCs classified as “disregarded entities” under the Check-the-Box Regulations, they must pay the Self-Employment Tax on the full amount of their LLC income except to the extent that this income consists of dividends, interest, capital gains, real estate rentals, or shares of limited partnership income. However:
 - Under Prop. Reg. § 1.1402(a)-2, they can achieve substantial lawful avoidance of the Self-Employment Tax if they are members of multi-member LLCs taxable as partnerships; and
 - Under Rev. Rul. 59-221, 1959-1 C.B. 225 and other authorities, they can entirely avoid FICA taxes on their shares of the income of single-member and multi-member LLCs if these LLCs have elected to be taxable as S corporations.
- 4) Rules governing LLC employer identification numbers. The IRS instructions for the use of Form SS-4 (“Application for Employer Identification Number”) provide advice and rules on the issue of how to obtain employer identification numbers for single-member and multi-member LLCs.
- 5) Employment tax duties of single-member LLCs. TD 9356 (August 16, 2007), a document published by the U.S. Treasury Department, contains final regulations governing the duties of LLCs classified as “disregarded entities” under the Check-the-Box Regulations with respect to employment tax payments and reporting.
- 6) Conversions of single-member LLCs to two-member LLCs and vice versa. Rev. Rul. 99-5, 1996-6 I.R.B. 8, and Rev. Rul. 99-6, 1996-6 I.R.B. 6, set forth IRS rules governing the federal income tax consequences of, respectively:
 - The conversion of single-member LLCs classified as disregarded entities to two-member LLCs classified as partnerships; and
 - The conversion of two-member LLCs classified as partnerships to single-member LLCs classified as disregarded entities.
- 7) Filing obligations of husband-wife LLCs. Rev. Proc. 2002-69, 2002-2 C.B. 831 provides, in essence, that when a husband and wife are the members of a two-member LLC taxable as a partnership, the LLC must file a partnership tax return (i.e., IRS Form 1065) unless the husband and wife reside in a community property state.
- 8) Statutory conversions of state-law business corporations to LLCs. PLR 200528021 (released on July 7, 2005) and PLR 200748021 (released on December 2, 2005), which I applied for and obtained for a New Hampshire client of mine, hold, in

essence, that, assuming that certain requirements are met, statutory conversions of state-law business corporations taxable under Subchapters C or S are tax-free reorganizations under IRC Section 361(a)(1)(F) and that the operating agreements of these entities are “governing provisions” for purposes of the Subchapter S single-class-of-stock rules.

- 9) Conversions of state-law partnerships to LLCs. Rev. Rul. 95-37, 1995-1 C.B. 130, provides that if a state-law general partnership taxable as a partnership converts to a multi-member LLC taxable as a partnership, then, if certain stated requirements are met (including a requirement that no liability of any partner may change in connection with the conversion), the conversion will not result in adverse partnership federal income tax consequences for the partnership or its partners. Thus, in essence, Rev. Rul. 95-37 provides that for federal tax purposes, the conversion will be treated for federal tax purposes as a non-event.
- 10) Treatment of managers of manager-managed multi-member LLCs under the passive activity loss (“PAL”) rules. Under Treas. Reg. Section 1.469-5T(e)(3)(i)(B), managers of manager-managed multi-member LLCs are treated as limited partners for purposes of the “material participation” PAL rules. By contrast, they are *not* treated as limited partners under Treas. Reg. 1-369-4T(3)(d), which, in general, prohibits limited partners from aggregating their activities for PAL purposes. (However, the Treasury Department issued the -5T rules before it began focusing on LLCs. It issued the -4T rules *after* it began focusing on LLCs. This presumably explains the inconsistency between the two sets of rules and provides an argument for challenging the validity of the -5T rules.)¹

If you have comments on this column or wish to contact me for any other reason, please send me an e-mail at lawjmc@comcast.net or give me a call at (603) 228-0125. If you'd like to visit my website, the link is www.llcformations.com.

¹ For the above explanation of the -4T and -5T rules, I am indebted to Robert Keatinge and Andrew Immerman for their posts in LNET-LLC, an internet discussion group on LLC law and tax.