JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ALL ISSUES IN A SINGLE PDF DOCUMENT

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ISSUE NO. 1 (AUGUST 1, 2003)

WHY DO LLCs MATTER?

THIS NEWSLETTER IS ABOUT LLC LAW, TAX AND PRACTICE. WHY BOTHER READING IT? HERE'S WHY.

In New Hampshire and many other states, LLCs are rapidly replacing corporations and other traditional business entities as the entities of choice for business start-ups. What are the reasons for this LLC Revolution? What does the LLC Revolution mean for your clients? And what does it mean for you as a CPA, EA or other tax or financial professional?

For many business people starting new businesses, LLCs have become the entities of choice because they offer BETTER LAW; for many others, because LLCs offer BETTER TAX; and for still others, because LLCs offer a better COMBINATION of law and tax.

To explain:

- LLC Legal Advantages for Single-owner Businesses. For individuals who are starting a new business, LLCs are the only entity that can simultaneously provide a LIABILITY SHIELD, CONTRACTUAL FLEXIBILITY, STATUTORY INFORMALITY, and OPTIMAL MANAGEMENT STRUCTURE. (I will explain all of these concepts in later issues of this Newsletter.)

  By contrast, corporations provide ONLY a liability shield, they are relatively formal and inflexible, and their management structure makes no sense for many small businesses. In short, for most individuals starting new businesses, LLC LAW IS BETTER LAW.

- LLC Tax Advantages of LLCs for Single-owner Businesses. Under the famous "Check-the-Box Regulations," LLCs are the only entities that can provide individuals who are starting new businesses with a choice between sole proprietorship taxation and taxation under Subchapters C and S.

  By contrast, state-law sole proprietorships can't provide Subchapter C or Subchapter S taxation, and corporations can't provide sole proprietorship taxation. In other words, for many individuals starting new single-owner businesses, LLC TAX IS BETTER TAX.

  In particular, only an LLC can simultaneously provide an individual business owner with (i) a liability shield and (ii) sole proprietorship taxation. Neither a corporation nor any other non-LLC entity can do this.

- LLC Legal and Tax Advantages for Multi-owner Businesses. LLCs offer multi-owner businesses the same legal advantages that they offer individuals. They also offer these businesses STATUTORY BUSINESS ASSET PROTECTION (a unique and critically important LLC legal advantage I'll discuss in future issues of this Newsletter). And they are the only entities that can simultaneously provide multi-

owner businesses with (i) a complete liability shield and (ii) a choice between taxation under Subchapter K (i.e., partnership taxation), Subchapter C and Subchapter S.

By contrast, corporations can't provide statutory business asset protection and they can't provide partnership taxation.

In short, when two or more persons form a business corporation to conduct their business, THIS IS VERY OFTEN A MISTAKE. The corporation should have been an LLC.

What does all this mean for you as a tax or financial professional? I'll address this question in the next issue of this Newsletter.

Has this Newsletter been useful to you? How can I improve it? What other topics should I address in it? Please let me know at lawjmc@comcast.net or give me a call at (603) 228-0125. And feel free to call me at that number if you have any questions about the Newsletter or about other LLC matters.

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JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 2 (SEPTEMBER 1, 2003)

THE BIG NINE

NINE TASKS THAT CPAs, EAs AND OTHER TAX AND FINANCIAL PROFESSIONALS SHOULD OFFER TO HANDLE FOR THEIR LLC FORMATION CLIENTS

If you are a CPA, an EA or other tax or financial professional and your clients (let's call them Mary and John) ask you to help them to form an LLC, what tasks should you normally offer to perform for them?

The short answer is, "nine of them" - unless, of course, Mary and John want to limit your engagement. I'll list all nine tasks below and, where useful, I'll briefly comment on them. As you'll see, many of these tasks deserve detailed discussion. I'll provide this discussion for each relevant task in later issues of this Newsletter.

1) Reach Agreement with Mary and John on the Scope of Your Engagement and Your Fee. As you'll see below, the list of things you do for Mary and John can be very short or very long. All of you should agree in advance what tasks the list will contain and what Mary and John will pay you to perform these tasks....

2) Handle Ethical Issues. The first ethical issue is always competence. For example, you shouldn't agree to conduct a tax choice-of-entity analysis for Mary and John unless you are reasonably expert at making these analyses.

Another issue always arises when, as in the case of Mary and John, two or more persons ask your help in forming an LLC. When this happens, you must first determine which of these persons is to be your client and which is not. If the answer is two or more of them, you must address with them potentially tricky issues of "joint representation."

3) Get the Business Facts. You have to get the basic facts about the business of Mary and John that are relevant to your tasks. To do this well, you'll need a good checklist of factual questions. I'll provide this checklist in a later issue of this Newsletter.

4) Do a Tax Choice-of-entity Analysis. You have to perform a tax choice-of-entity analysis for Mary and John. That is, you have to decide which of the three principal federal income tax regimen regimens (i.e., taxation under Subchapters C, K and S) is best for them (a) for federal income tax purposes; (b) for Social Security Tax purposes; and (c) for state and multi-state income tax purposes.

5) Resolve Any Conflicts as to Best Federal Income Tax Regimen. If one federal income tax regimen is best for Mary and John for one type of tax, while

another is best for another, you have to help them resolve the conflict. For example, for federal income tax purposes, Mary and John may need partnership taxation, but for Social Security Tax avoidance, they may need Subchapter S. You've got to help them decide which type of tax is more important to them on a net basis in the short, middle and long term, and you have to help them choose their federal income tax regimen accordingly.

6) Do a Check-the-Box Analysis. You have to perform a "Check-the-Box analysis." That is, on the basis of the Check-the-Box Regulations, you have to tell Mary and John which types of state-law entities that are available to them under the governing state law can qualify for the federal income tax regimen that is best for them.

For example, under the Check-the-Box Regulations, if Mary and John want partnership taxation but they also want to use a state-law business corporation to conduct their business, they've got a problem. This is because under Check-the-Box, corporations can't qualify for partnership tax. You have to help Mary and John solve this problem.

7) Identify and Handle Financial Issues. You have to identify and help Mary and John handle the financial issues relevant to their LLC's formation. In particular, in connection with the formation of multi-member LLCs, you may have to help them negotiate these issues between themselves and with other parties to the formation. You may also have to review drafts of operating agreement provisions that address these issues so that you can ensure that they meet Mary's and John's needs.

The relevant operating agreement provisions may to include, among others, those addressing:

- The fiscal year and accounting method of the LLC;
- Capital contributions, allocations of income and loss, and interim and liquidating distributions to the members; and
- Buy-sell arrangements.

It may also be appropriate for you to advise Mary and John about:

- The accounting procedures they should set up to ensure that their LLC maintains sound financial records and the software they should use for that purpose;
- Financial issues in their business plan (whether they have written up a plan or merely carry on in their head); and
- How they should handle payroll issues, including payroll reporting.

8) Handle Tax Issues within the Chosen Federal Income Tax Regimen. You have to handle the tax issues that arise for Mary and John within the federal income tax regimen you've helped them choose. For a single-owner business, these issues will usually be few and simple. But for multi-member LLCs

classified as partnerships or Subchapter S corporations for federal tax purposes, they can be numerous and complex.

For example, a common and often difficult partnership tax issue is how to handle tax distributions. (Another tax function in LLC formations that is very basic but that can be complex in some situations is the obtaining of tax identification numbers.)

9) Help Mary and John Find a Good LLC Lawyer. Finally, once you've finished your tax and financial tasks, Mary and John may want you to help them find a good lawyer to handle their LLC legal needs.

If you'd like to see where the above nine tasks fit within the overall job of forming LLCs and what types of tasks are usually handled by lawyers, click on the "articles" link in www.cunningham-seminars.com and then click on Item 21.

For any other questions you may have relating to this issue of the Newsletter, please feel free to give me a call at (603) 228-0125 or to send me an e-mail at lawjmc@comcast.net.

I will greatly appreciate any comments you may have about this issue.

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS

THE CHECK-THE-BOX REGULATIONS IN A NUTSHELL – PART I

ISSUE NO. 3 (OCTOBER 2, 2003)

If you are a CPA or an EA and you want to help business start-up clients, the single most important federal tax authority you have to understand next to the Internal Revenue Code itself is the famous set of U.S. Treasury Department regulations known as the Check-the-Box Regulations. These regulations became effective on January 1, 1997. You have to know how to apply the Check-the-Box Regulations in two quite different types of situations:

- CLIENTS HAVE ALREADY CHOSEN BUSINESS ENTITY. In the first situation, your clients have already decided on the type of state-law business entity they want to use in their new business. In this situation, your job is to tell your clients which types of federal income tax regimens (*i.e*., sole proprietorship taxation or taxation under Subchapters C, K or S) will be available to them if they use that entity in their new business. I'll refer to the rules you should apply in this situation as the "standard" Check-the-Box rules.

> EXAMPLE. Your client Mary Doe has already formed a single-member LLC to conduct her new business. She asks your help as to tax and financial matters in setting up her business. You must apply the "standard" Check-the-Box Rules to tell her which federal income tax regimens are available for her single-member LLC.

- CLIENTS HAVE NOT YET CHOSEN BUSINESS ENTITY. In the second situation, your clients haven't yet chosen a state-law business entity. In this situation, you must first decide which federal income tax regimen will be best for your clients. You must then tell the clients which types of state-law business entities can qualify for that regimen. I'll refer to the rules you should apply in this situation as the "reverse" Check-the-Box rules.

> EXAMPLE. Your client Tom Roe asks for your help in starting a new business. He hasn't yet formed or chosen any state-law business entity for his new business. You have to tell him which federal income tax regimen will be best for his business and then you have to tell him which New Hampshire state-law business entities qualify for that regimen.

In this issue of this Newsletter, I'll state and illustrate the "standard" Check-the-Box Rules. In the next issue, I'll do the same for the "reverse" rules.

THE SIX "STANDARD" CHECK-THE-BOX RULES

1) (1) CLIENTS HAVE CHOSEN STATE-LAW BUSINESS CORPORATION. If your clients have chosen to use a state-law business corporation, their default federal income tax regimen is Subchapter C, but if they meet the Subchapter S eligibility and election rules, they can, of course, elect Subchapter S, using IRS Form 2553.

EXAMPLE: Your client Tom Jones has already formed a state-law business corporation for his new business. He can get Subchapter C or Subchapter S taxation, but he can't get sole proprietorship taxation.

(2) CLIENT IS INDIVIDUAL AND HAS CHOSEN STATE-LAW SOLE PROPRIETORSHIP. If your client has chosen to use a state-law sole proprietorship, the only federal income tax regimen available to your client is sole proprietorship federal income taxation.

EXAMPLE: Same facts as above, but Tom wants to conduct his new business as a state-law sole proprietorship. He can only get sole proprietorship taxation; he can't get Subchapter C or Subchapter S.

(3) CLIENT IS INDIVIDUAL AND HAS CHOSEN SINGLE-MEMBER LLC. If your client is an individual and has chosen to use a single-member LLC, the client's default federal income tax regimen is sole proprietorship taxation. However, the client can elect Subchapter C under IRS Form 8832, and, if he or she meets the Subchapter S requirements, the client can elect into Subchapter S (using, of course, Form 2553).

EXAMPLE: Same facts as above, but Tom wants to conduct his business as a single-member LLC. He can get sole proprietorship taxation or taxation under Subchapters C or S.

(4) CLIENT IS ENTITY AND HAS CHOSEN DIVISION. If your client is an entity that has chosen to conduct one or more units of its business as divisions (*i.e.*, as unincorporated administrative units), these divisions will be disregarded by the IRS and their tax items will be treated as those of its owner.

EXAMPLE. Your client XYZ, Inc. is starting a new line of business and wants to conduct it through a division. XYZ can only get pass-through taxation. It can't get Subchapter C (but probably wouldn't want it anyway).

(5) CLIENT IS ENTITY AND HAS CHOSEN SINGLE-MEMBER LLC. If your client is an entity and has chosen to conduct one more units of its business as single-member LLCs, the default federal income taxation of these single-member LLCs will be that of "disregarded entities," and the tax items of these single-member LLCs will be deemed to be those of their owner. However, if the entity so chooses, it can elect to have its single-member LLCs taxable under Subchapter C. (This choice will, of course, be made very rarely.)

EXAMPLE: Same facts as above, but XYZ, Inc. has formed a single-member LLC to conduct its new line of business. The new single-member LLC can get either divisional tax treatment or taxation under Subchapter C.

(6) CLIENTS HAVE CHOSEN LLC OR OTHER "MULTI-OWNER UNINCORPORATED BUSINESS ENTITY". If your clients have chosen to use an LLC or other "multi-owner unincorporated entity" then the default federal income tax regimen of your clients' entity will be that of a partnership taxable under Subchapter K. Under New Hampshire law, there are four kinds of unincorporated multi-owner business entities – namely, (i) LLCs, (ii) general partnerships that are not limited liability partnerships, (iii) LLPs, and (iv) limited partnerships). If your clients have chosen to use any of these types of entities in their business, they can elect to have the entity taxable under Subchapter C and, if they meet Subchapter S requirements, under Subchapter S.

EXAMPLE: Your clients Tom Jones and his wife Mary have formed a two-member LLC to conduct a new business of which they will be equal owners. The default taxation of their LLC will be partnership taxation under Subchapter K. However, Tom and Mary can elect to have their LLC taxed under either Subchapter C or Subchapter S.

Next month: The eight "Reverse" Check-the-Box Rules.

I've discussed all of the above rules and their practical impact in considerable detail in Chapter 9 of a handbook I've just finished writing for New Hampshire CPAs on LLC formations and conversion practice. If you'd like a copy of this chapter, just give me a call or send me an e-mail.

Has this Newsletter been useful to you? How can I improve it? What other topics should I address in it? Please let me know at lawjmc@comcast.net or give me a call at (603) 228-0125. And feel free to call me at that number if you have any questions about the Newsletter or about other LLC matters.

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JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

THE CHECK-THE-BOX REGULATIONS IN A NUTSHELL – PART II

THE EIGHT "REVERSE CHECK-THE-BOX RULES" THAT TAX PROFESSIONALS SHOULD KNOW HOW TO APPLY WHEN THEIR BUSINESS CLIENTS HAVE NOT YET DECIDED ON THE TYPE OF STATE-LAW BUSINESS ENTITY THEY WILL USE IN THEIR BUSINESS

ISSUE NO. 4 (NOVEMBER 1, 2003)

The single most important task that you as a CPA, EA and other tax professional must perform for your business start-up clients is normally that of helping them to choose the best federal income tax regimen for their business. This regimen – which, depending on the facts, will be either sole proprietorship taxation or taxation under Subchapters C, K or S - will of course determine the federal income tax liability of the clients' business and of the clients themselves as business owners. It will also determine the clients' liability for Social Security Taxes. Finally, in most states (including, to a degree, New Hampshire), it will determine the state income tax liabilities of their businesses and of themselves as business owners.

However, once you have resolved this issue for your client, you must then decide how the famous Check-the-Box Regulations will apply to your clients. These regulations can apply in two quite different situations.

- Situation # 1 – Your Client Has Already Chosen State-law Business Entity. The first situation is when your clients have already formed a particular type of state-law business entity for their business (*e.g.*, a state-law business corporation or an LLC) or at least have made a final decision as to the type of entity they want. This situation requires the application of the six "standard" Check-the-Box rules. These rules are set forth in Issue No. 3 of this Newsletter (entitled "The Check-the-Box Regulations in a Nutshell"), dated October 2, 2003.

  EXAMPLE. Your client Mary Jones has formed a new state-law business corporation to conduct her business. Applying Rule 1 of the above "standard" Check-the-Box Rules, you advise Mary that the only federal income tax regimens available to her business as a state-law business corporation are Subchapters C and S. Under these rules, Mary *cannot* simultaneously conduct her business as a state-law business corporation and exploit the unique tax advantages of sole proprietorship federal income taxation.

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- <u>Situation # 2 – Client Has Not Yet Chosen State-law Business Entity</u>. The second situation is when you have advised your clients which type of federal income tax regimen will be best for their business, but your clients have not yet decided on the type of state-law business entity they want to use in conducting that business.

  In this situation, you need to be familiar with the eight "reverse" Check-the-Box Rules. These rules will tell you which types of state-law business entities can qualify for the federal income tax regimen that your clients need.

  > <u>EXAMPLE</u>. Your client Mary Jones is forming a new business. You advise her that the best federal income tax regimen for her from a combined federal income tax, Social Security Tax and state tax viewpoint is sole proprietorship taxation. Now you must decide which of the available state-law entities can provide her with that regimen under the Reverse Check-the-Box Rules.

<u>The Seven Available Types of State-law Business Entities</u>. Under New Hampshire law and the law of most other states, there are seven main types of state-law business entities from which clients can choose in selecting the entity that will best suit their business – namely:

2) State-law sole proprietorships;
3) Divisions (*i.e.,* administrative units of entities);
4) Traditional general partnerships (*i.e.,* state-law general partnerships that have not elected to be limited liability partnerships ("LLPs") under state-law law and thus have not provided their partners with at least a partial liability shield);
5) LLPs;
6) Limited partnerships;
7) Corporations; and
8) LLCs.

Obviously, the only entities among the above seven types of entities that can be used by *single*-owner businesses are sole proprietorships, single-shareholder corporations and single-member LLCs; while the entities that can be used by *multi*-owner businesses are traditional general partnerships, LLPs, limited partnerships, multi-shareholder corporations and multi-member LLCs.

<u>The Reverse Check-the-Box Rules</u>. As indicated above, there are eight Reverse Check-the-Box Rules. This may seem like a lot of rules to learn, but fortunately, each of the eight rules is simple to understand and apply.

The eight Reverse Check-the-Box Rules, as applicable in specific hypothetical situations, are as follows:

(1) CLIENT IS INDIVIDUAL AND WANTS SOLE PROPRIETORSHIP FEDERAL INCOME TAXATION. Your client – whom we'll call Mary Jones - is an individual and needs *sole proprietorship federal income taxation*. Under Reverse Check-the-Box Rule 1, Mary's state-law business entity *cannot* be a state-law business corporation, but it *can* be either:

a) A state-law sole proprietorship; or

b) A single-member LLC.

If, like many individuals who own single-owner businesses, Mary needs a liability shield, she must reject the use of a state-law sole proprietorship for her business and must use a single-member LLC. There is no other option. (She will need a liability shield if, for example, she has even a single employee. You never know what your employees will do to create liability for you.)

(2) CLIENT IS INDIVIDUAL AND NEEDS SUBCHAPTER C. Mary, an individual, needs *Subchapter C taxation*. Under Reverse Check-the-Box Rule 2, Mary's state-law business entity *cannot* be a state-law sole proprietorship, but it *can* be either:

a) A state-law business corporation; or

b) A single-member LLC that uses a Form 8832 to make a Subchapter C election.

(3) CLIENT IS INDIVIDUAL AND NEEDS SUBCHAPTER S. Mary, an individual, wants *Subchapter S taxation*. Under Reverse Check-the-Box Rule 3, Mary's state-law business entity *cannot* be a state-law sole proprietorship, but it *can* be either

a) A state-law business corporation that makes an S election; or

b) A single-member LLC that elects into Subchapter C under Form 8832 and then into Subchapter S under Form 2553.

(4) CLIENT IS ENTITY AND NEEDS DIVISIONAL FEDERAL INCOME TAXATION. XYZ, Inc., an entity, needs each of its wholly owned business units to be taxable as *divisions*. Under Reverse Check-the-Box Rule 4, these business units *cannot* be state-law business corporations, but *can* be either:

a) Divisions; or

b) Single-member LLCs that accept the default federal income tax classification of "disregarded entities."

(5) CLIENT IS ENTITY AND NEEDS ITS SUBSIDIARY BUSINESS UNITS TO BE TAXABLE UNDER SUBCHAPTER C. XYZ, Inc., an entity, needs its wholly owned business units to be taxable under *Subchapter C*. Under Reverse Check-the-Box Rule 5, these units *cannot* be divisions, but they *can* be either:

a) State-law business corporations; or

b) Single-member LLCs that elect to be Subchapter C corporations by using Form 8832.

(6) CLIENTS ARE TWO OR MORE INDIVIDUALS OR ENTITIES AND NEED PARTNERSHIP TAXATION. Jones and Smith are two or more individuals or entities that need their jointly owned entity to be taxable as a *partnership under*

Subchapter K. Under Reverse Check-the-Box Rule 6, their state-law business entity *cannot* be multi-shareholder corporations, but it *can* be any type of multi-owner unincorporated business entity – *i.e*., it can be either:

a) Traditional general partnerships;

b) LLPs;

c) Limited partnerships; or

d) Multi-member LLCs.

(7) CLIENTS ARE TWO OR MORE INDIVIDUALS OR ENTITIES AND NEED SUBCHAPTER C TAXATION. Jones and Smith are two or more individuals or entities that want their jointly owned entity to be taxable as a Subchapter C corporation. Under Reverse Check-the-Box Rule 7, this entity can be either:

a) A multi-shareholder state-law business corporation that accepts the default federal income tax regimen of Subchapter C; or

b) Any of the above types of unincorporated business entities as long as this entity elects Subchapter C by using Form 8832.

(8) CLIENTS ARE TWO OR MORE QUALIFIED SUBCHAPTER S SHAREHOLDERS AND NEED SUBCHAPTER S TAXATION. Two or more individuals or other persons (*e.g*., individuals who are U.S. citizens, resident aliens or Qualified Subchapter S Trusts) need their entity to be taxable as a *Subchapter S corporation*. Under Reverse Check-the-Box Rule 8, this entity can be either:

a) A state-law business corporation that makes a Subchapter S election; or

b) Any of the above types of unincorporated business entities as long as it elects Subchapter C by using Form 8832 and then elects Subchapter S by using Form 2553.

As I mentioned above, the fact that to advise your clients as to the type of state-law entity they will need in order to obtain the federal income tax regimen they need may sound daunting. However, I can assure you that when you actually begin applying these eight rules to actual client situations, you'll find the task an easy one.

If, however, despite the above assurance, you find it difficult to get a firm grip on the six Standard Check-the-Box Rules I discussed in last month's issue of this Newsletter and the eight Reverse Check-the-Box Rules I've discussed in this one, help is on the way: In next month's issue, I'll provide a clear and practical summary of all 16 of these rules in two simple charts.

Has this Newsletter been useful to you? How can I improve it? What other topics should I address in it? Please let me know at lawjmc@comcast.net or give me a call at (603) 228-0125. And feel free to call me at that number if you have any questions about the Newsletter or about other LLC matters.

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS

THE CHECK-THE-BOX REGULATIONS IN A NUTSHELL – PART III

ISSUE NO. 5 (DECEMBER 1, 2003)

THE "STANDARD" AND "REVERSE" CHECK-THE-BOX RULES IN TABULAR FORM

Dear Colleagues:

As you know, next to doing tax choice-of-entity analyses, the most important task that tax professionals must perform in assisting clients to start new businesses is to perform Check-the-Box analyses for them. As you may recall from the last two issues of this Newsletter, the need for these analyses arises in two quite different situations:

- Applying the Seven "Standard" Check-the-Box Rules. In the first situation, your clients have already formed a state-law business entity to conduct their business – *e.g.*, a state-law business corporation, an LLC, or a limited partnership – before coming to you for tax advice. In this situation, after advising them as to which federal tax regimen (i.e., sole proprietorship taxation or taxation under Subchapters C, K or S) is best for them, you must then advise them whether, under the seven "standard" rules set forth in the Check-the-Box Regulations and other federal tax authorities, their entity can qualify for this regimen. Friends of mine in the CPA and EA communities have suggested to me that a need to apply these "standard" rules arises in the case of roughly 20% of their business start-up clients.

  EXAMPLE: Before seeing you, your clients John and Mary Doe have formed a New Hampshire business corporation to conduct their new retail business. When they meet with you, you advise them that for federal income and Social Security Tax purposes and for New Hampshire state tax purposes, the best tax regimen for them is Subchapter K (partnership taxation). Then, applying the "standard" Check-the-Box rules, you advise them that their corporation cannot qualify for Subchapter K treatment and that they must either accept Subchapter C and S taxation or form another state-law business entity – for example, an LLC – that, under these rules, does qualify to be taxed under Subchapter K.

- Applying the Eight "Reverse" Check-the-Box Rules. In the second situation, your clients have not yet formed a state-law business entity to conduct their business before visiting you. In this situation, after having advised them of the federal tax regimen that will be best for them, you apply the eight "reverse" Check-the-Box rules to advise them as to which types of state-law business entities qualify for treatment under that regimen. CPAs and EAs have suggested to me that they find themselves applying the "reverse" Check-the-Box rules in the case of at least 80% of their business start-up clients.

EXAMPLE: Your clients John and Mary Doe come to you for tax advice before forming any state-law business entity to conduct their new retail business. You advise them that the best federal tax regimen for their business is Subchapter K. Then, applying the "reverse" Check-the-Box rules, you advise them that any type of state-law multi-owner unincorporated business entity can qualify for Subchapter K tax treatment and that only a state-law business corporation cannot qualify for this treatment. You then advise them that multi-owner unincorporated business entities include traditional general partnerships, limited liability partnerships ("LLPs"), limited partnerships and LLCs. Now it is up to John and Mary's business lawyer to advise them as to which of these types of entities will be best for them from a nontax viewpoint.

In my tax practice, I have found that once I understand the theory underlying any area of tax, I can best apply this theory if I first set forth its basic elements in the form of one or more tables. In particular, I find tables to be useful in applying the standard and reverse Check-the-Box rules. Set forth below are both of these tables in the form in which I use them in making Check-the-Box analyses. I doubt that you will find these two tables entirely self-explanatory, but I hope that on the basis of the theoretical discussions in Issues 3 and 4 of this Newsletter, you will find them to be practical tools in making Check-the-Box analyses. I am also including this Newsletter as an attachment to this e-mail as a Word document in case your e-mail program has difficulty with e-mail messages containing relatively complex formats such as tables.

TABLE 1 - THE SEVEN "STANDARD" CHECK-THE-BOX RULES

TYPE OF STATE-LAW ENTITY	FEDERAL TAX CLASSIFICATION	DEFAULT FEDERAL INCOME TAX REGIMEN	FEDERAL INCOME TAX REGIMENS AVAILABLE FOR ELECTION	FEDERAL INCOME TAX REGIMENS UNAVAILABLE TO ENTITY
1. Corporation – one shareholder	Corporation	Subchapter C	Subchapter S (subject to Subchapter S eligibility and election requirements)	Sole proprietorship
2. Corporation – two or more shareholders	Corporation	Subchapter C	Subchapter S (subject to Subchapter S eligibility and election requirements)	Subchapter K
3. Sole proprietorship	None	Sole proprietorship	None	Subchapters C, K and S
4. Division	None	Regimen of owner	None	Regimen different than that of owner
5. Single-member	Disregarded entity	Regimen of owner	Subchapter C	Subchapter K

TYPE OF STATE-LAW ENTITY	FEDERAL TAX CLASSIFICATION	DEFAULT FEDERAL INCOME TAX REGIMEN	FEDERAL INCOME TAX REGIMENS AVAILABLE FOR ELECTION	FEDERAL INCOME TAX REGIMENS UNAVAILABLE TO ENTITY
LLC owned by individual			Subchapter S (subject to Subchapter S eligibility and election requirements)	
6. Single-member LLC owned by entity	Disregarded entity	Regimen of owner	Subchapter C Subchapter S (subject to Subchapter S eligibility and election requirements)	Subchapter K
7. Multi-owner unincorporat-ed business entity (includes (i) non-LLP general partnership, (ii) LLP; (iii) limited partnership and (iv) LLC	Partnership	Subchapter K	Subchapter C Subchapter S (subject to Subchapter S eligibility and election requirements)	Sole proprietorship taxation

[TABLE 2, WHICH PRESENTS THE "REVERSE" CHECK-THE-BOX RULES, BEGINS ON THE NEXT PAGE.]

TABLE 2 - THE EIGHT "REVERSE" CHECK-THE-BOX RULES

RULE NUMBER	NUMBER AND TYPE OF BUSINESS OWNERS	CLIENT WANTS THE FOLLOWING FEDERAL INCOME TAX REGIMEN	AVAILABLE TYPES OF STATE-LAW ENTITIES	COMMENTS
1)	One owner, who is an individual	Sole proprietorship taxation	1. State-law sole proprietorship 2. Single-member LLC	Under the Check-the-Box Regulations, sole proprietorship taxation is the default federal income taxation for single-member LLCs owned by individuals.
2)	One owner, who is an individual	Subchapter C taxation	1. State-law corporation 2. Single-member LLC	Under the Check-the-Box Regulations, individuals who own single-member LLCs may elect Subchapter C taxation by using Form 8832.
3)	One owner, who is an individual	Subchapter S taxation	1. State-law corporation 2. Single-member LLC	Shareholders of state-law corporations and members of single-member LLCs who have elected Subchapter C may elect Subchapter S taxation using Form 2553.
4)	One owner, which is an entity	Division of owner	1. Division 2. Single-member LLC	Under the Check-the-Box Regulations, the default federal tax treatment of single-member LLCs owned by entities is divisional treatment.
5)	One owner, which is an entity	Subchapter C taxation	1. Division; 2. Corporation 3. Single-member LLC	Under the Check-the-Box Regulations, entities that own single-member LLCs may elect Subchapter C treatment for these LLCs.

RULE NUMBER	NUMBER AND TYPE OF BUSINESS OWNERS	CLIENT WANTS THE FOLLOWING FEDERAL INCOME TAX REGIMEN	AVAILABLE TYPES OF STATE-LAW ENTITIES	COMMENTS
6)	Two or more individuals or entities	Subchapter K taxation	Any type of multi-owner unincorporated business entity	There are four main types of multi-owner unincorporated business entities – namely: 1. Non-LLP general partnership 2. LLP 3. Limited partnership 4. LLC Under the Check-the-Box Regulations, the default tax treatment of multi-owner unincorporated business entities is taxation under Subchapter K.
7)	Two or more individuals or entities	Subchapter C taxation	1. Any type of multi-owner unincorporated business entity 2. Corporation	Under the Check-the-Box Regulations, owners of multi-owner unincorporated business entities may elect Subchapter C treatment for their entities using Form 8832.
8)	Two or more individuals or other persons (e.g., QSSTs) permitted to be Subchapter S shareholders	Subchapter S taxation	1. Any type of multi-owner unincorporated business entity 2. Corporation	See note immediately above. Under Subchapter S, any entity (including a multi-owner unincorporated business entity) that meets Subchapter S requirements may elect Subchapter S treatment.

A parting message: During the past few months, many of you have called or e-mailed me with LLC tax and legal questions that have arisen in your practice. I love receiving these questions, and I always learn something from answering them. Please keep them coming! If you care to call me, my telephone number is (603) 228-0125. My e-mail address is lawjmc@comcast.net.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 6 (JANUARY 1, 2004)

CONVERTING CORPORATIONS TO LLCs TO AVOID THE NEW HAMPSHIRE INTEREST & DIVIDENDS TAX

Dear colleagues:

As you no doubt know, for New Hampshire corporations and their shareholders, the combined impact of the 8.5% Business Profits Tax and the 5% Interest and Dividends Tax makes New Hampshire one of the harshest tax environments in the United States. A 13.5% combined state tax on businesses and their owners is a cruel fiscal burden.

However, I've recently come to realize that there is a partial but important solution to the problem of New Hampshire corporate taxation. In brief summary:

- As you probably know, RSA 77:4, III, provides that members of LLCs that have nontransferable shares are not liable for the I&D Tax.

- Furthermore, New Hampshire statutory business organization law makes it relatively easy to convert a corporation to an LLC through what is called a "statutory conversion."

- Finally, under the Check-the-Box Regulations, an entity that, for state-law purposes, is a corporation can convert to an LLC while still being taxable under IRC Subchapters C or S, and the conversion will not result in a deemed corporate dissolution or in corporate "death taxes."

Thus, if a New Hampshire corporation properly converts to an LLC, its shareholders who are New Hampshire residents will no longer have to pay the I&D Tax on their corporate dividends.

> EXAMPLE: XYZ, Inc., an S corporation, is a New Hampshire business corporation that pays its shareholders annual dividends totaling $200,000. All of these shareholders are New Hampshire residents. The shareholders, in turn, pay substantial annual I&D Tax. On January 1, 2004, XYZ converts to an LLC and files the appropriate IRS forms to preserve its S election. XYZ's LLC agreement prohibits each of its members from selling or otherwise transferring his or her LLC membership except with the consent of at least one other member.
>
> The result of all this: XYZ, while it is still an S corporation for federal tax

purpose, is now an LLC for law purposes, and its owners are thus no longer liable for the I&D Tax.

There is always, of course, a possibility that the New Hampshire Department of Revenue Administration will obtain an amendment to the I&D Tax that will eliminate the above tax avoidance opportunity. However, the amendment will necessarily create a "new tax." I question whether Craig Benson and the Legislature will impose such a tax, especially since it will hurt small businesses and raise serious New Hampshire constitutional issues.

Planning point: Many New Hampshire corporations are now avoiding the BPT and the I&D Tax by "comping out." However, if they convert to LLCs with nontransferable shares and if they then significantly reduce compensation to shareholder-employees, the resulting FICA avoidance may yield substantial net tax savings for these shareholders.

The statutory conversions I've described above can be complex and tricky and may require significant legal and accounting expertise. Thus, they can be expensive. However, for some corporations, the recurring annual I&D Tax savings from conversions will far outweigh the one-time costs. In addition, the conversion can yield major nontax benefits, such as statutory asset protection, that LLCs provide but corporations don't.

On December 28, 2003, the Concord Monitor published an article of mine about the above subject. In case you're interested, I'm attaching a copy of the article.

If you have any questions or comments about the above statutory conversion technique for avoiding the I&D Tax, please feel free to call me at (603) 228-0125; or send me an e-mail.

Has this Newsletter been useful to you? How can I improve it? What other topics should I address in it? Please let me know at lawjmc@comcast.net or give me a call at (603) 228-0125. And feel free to call me at that number if you have any questions about the Newsletter or about other LLC matters.

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JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 7 (FEBRUARY 1, 2004)

THE THREE "SECTION 47 PROTECTIONS" – THE KEY DISTINGUISHING FACTORS BETWEEN LLCs AND CORPORATIONS

A Plain-English Explanation for Non-lawyers

Dear Colleagues:

I want to devote this issue of my LLC newsletter to certain critically important LLC legal features provided by the New Hampshire LLC Act. (Similar features are provided by all other LLC acts except those of Nebraska and Pennsylvania.) In my experience, these features are understood by almost no New Hampshire business people, by relatively few New Hampshire CPAs and other New Hampshire financial professionals, and indeed, by only a small portion of New Hampshire business lawyers.

I'm referring to the three protections provided under Section 47 of the New Hampshire LLC Act.

Section 47 provides, in essence, that if an LLC member in his or her personal capacity incurs a judgment on a debt incurred outside the LLC's business and fails to satisfy the judgment by paying the debt, the judgment creditor can obtain from a court a "charging order" that will require the LLC to pay to the creditor any distributions that it would otherwise pay to the debtor-member. (Distributions mean amounts paid to LLC members simply because they are members and not because of any services they render to or on behalf of their LLC.)

> EXAMPLE. John Doe is the 51% owner of Doe Construction, LLC, a construction company with receivables, equipment and other assets worth $5 million. John's wife Mary has a 49% ownership interest in John's LLC. On February 1, 2004, John is driving his car on purely personal business when, accidentally but negligently, he runs over and kills Bob Smith, M.D., a brain surgeon. Bob's estate obtains a judgment of $10 million against John, which vastly exceeds John's automobile insurance coverage. In these circumstances, Section 47 authorizes Bob's estate to obtain a charging order against the Doe LLC. If, after it has obtained this order, John's LLC makes any distributions intended for John, these distributions must go instead to Bob's estate.

However, Section 47 provides not only that judgment creditors of members of multi-member LLCs can obtain charging orders against these LLCs. It also implicitly provides that these charging orders are the ONLY relief that the creditors can obtain with respect to the LLC. Thus, as explained in the bullet points below, Section 47 implicitly provides three quite separate and but closely related types of protection for members of multi-member LLCs. And each of these types of protection can be of tremendous practical importance to these owners.

- Protection of debtor-member's ownership of his or her LLC management rights. First, Section 47 protects LLC debtor-members from losing their LLC management rights to judgment creditors. This means, in the above example, that John Doe will retain his LLC voting rights, information rights, agency right (i.e., his right to sign LLC contracts) and dispute resolution rights, and that all of these rights will be beyond the reach of Bob's estate.

- Protection of non-debtor members from unwanted new co-member. Second, Section 47 protects the non-debtor members of multi-member LLCs in which one of the members is in default on a personal debt from having to accept the debtor-member's creditor as a new and unwanted member of their LLC. In the above example, this means that Mary will not have to accept Bob's estate as a new (and controlling) member of the Doe LLC.

- Protection of LLC business assets. Third, assuming – as in the above example - that the LLC debtor-member in default is the controlling member, Section 47 protects all of the members (including both the debtor-member and the NON-debtor members) from the judgment creditor's being able to force the sale of the LLC's assets in satisfaction of the debtor-member's debt. This means that the debtor-member and the non-debtor members can continue to operate the LLC's business as a going concern. It also means that although the debtor-member will no longer be able to obtain a share of LLC distributions, he or she can still obtain a salary or guaranteed payment for services rendered to or on behalf of the LLC. Under the right circumstances, this salary or guaranteed payment can be a substantial equivalent of the debtor-member's LLC distributions.

In seminars that I teach to CPAs, EAs, lawyers and business people, I often make the statement that most new corporations are mistakes – they should have been LLCs. And I routinely assert in these seminars that many existing corporations should convert to LLCs.

There are many legal and tax reasons why I believe these statements are true. However, for most business owners, the biggest reason of all is Section 47. There is no provision in the New Hampshire Business Corporation Act or in any other corporate statute that provides any of the three legal protections provided by Section 47. This fact alone (not to mention other legal reasons and a host of tax reasons) makes LLCs preferable to corporations for most business owners.

If you have any questions about Section 47 or about any other LLC legal or tax features, please feel free to contact me by phone at (603) 228-0125 or by e-mail at lawjmc@comcast.net.

Has this Newsletter been useful to you? How can I improve it? What other topics should I address in it? Please let me know at lawjmc@comcast.net or give me a call at (603) 228-0125. And feel free to call me at that number if you have any questions about the Newsletter or about other LLC matters.

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 8 (MARCH 1, 2004)

WHAT YOUR LLC CLIENTS SHOULD DO TO PROTECT THEIR LIABILITY SHIELD YOUR

Dear Colleagues:

Most of us have clients who conduct their businesses as LLCs. The main reason why many of these clients use LLCs in their businesses is to obtain the LLC statutory "liability shield" – i.e., the shield that protects their homes, securities and other assets from claims against their business.

However, the protection afforded by this shield is not automatic; LLC owners have to do various things in order to maximize its protection and to prevent third parties from "piercing the veil" of their LLC.

Set forth below are seven "anti-veil-piercing" guidelines that I often provide to my LLC clients. In case it's useful to you, I'm also attaching a copy of these guidelines as a Word document.

If you agree with the content of the guidelines, you may want to provide them to your LLC clients. And you should feel quite free to do so; I make no copyright claim for them.

SEVEN THINGS YOU SHOULD DO TO PROTECT YOUR LLC FROM VEIL PIERCING

The main reason many New Hampshire business people use LLCs to conduct their businesses is to obtain an LLC liability shield. If you're an LLC member or manager, this statutory shield will protect your personal assets from claims against your LLC unless these claims result from your own misconduct in doing the LLC's business.

However, as a growing body of LLC case law makes clear, there is always the risk that in certain circumstances, a court may "pierce the veil" of your LLC. That is, if you fail to comply with LLC anti-veil-piercing guidelines, the court may simply disregard your LLC liability shield and hold you personally liable for claims against your LLC even if, in conducting the LLC's business, you *haven't* engaged in personal misconduct.

To avoid LLC veil piercing, here are the seven guidelines you should follow:

Guideline 1. DON'T USE YOUR LLC TO COMMIT FRAUD OR OTHER SERIOUS MISCONDUCT

The courts will often pierce an LLC's veil if, in their view, any of the members has used the LLC to commit fraud or other deliberate and serious misconduct but seeks to rely on the LLC liability shield to avoid personal liability. Thus, to avoid veil piercing (and, obviously, for many other strong legal and ethical reasons as well), you and all of your LLC co-members should avoid any such misconduct.

However, not only deliberate but also *unintentional* misconduct may lead the courts to pierce an LLC's veil. That's why you should comply not only with Guideline 1 but also with the other six guidelines in this article.

Guideline 2. MAKE SURE THAT YOUR PERSONAL BOOKS, RECORDS AND BANK ACCOUNTS ARE MAINTAINED SEPARATELY FROM THOSE OF YOUR LLC

The legal theory that is the basis for the LLC liability shield is that LLCs and their members are independent legal persons separate and distinct from one another. To protect your LLC liability shield, you should take every reasonable means to implement and document this separateness. For example:

- You should keep separate books and records and separate bank accounts for, on the one hand, your own personal affairs and, on the other, the business and affairs of your LLC.

- You shouldn't withdraw money from your LLC's account for personal use, nor should you deposit money in that account, without making and maintaining accurate written records of these transactions that reflect arm's-length terms.

Guideline 3. DON'T USE LLC PROPERTY AS IF IT WERE YOUR OWN PERSONAL PROPERTY

In small, informal LLCs, it can be tempting for members to use LLC property as if it were their personal property. However, any such use can support a plaintiff's veil-piercing claim. Thus, whenever you make significant personal use of your LLC's property, you should document that use and compensate the LLC for it as if you were a third party.

Guideline 4. WHEN YOU DEAL WITH THIRD PARTIES, MAKE IT CLEAR TO THEM THAT THEY ARE DEALING WITH AN LLC, NOT WITH YOU AS AN INDIVIDUAL

In dealing with suppliers, customers and other third parties, you should make it clear to them that they are doing business with your LLC and not with you as an individual.

Thus, for example, you should ensure that the initials "LLC" or the like appear after the name of your LLC in its stationery and invoices, on its business cards and on other printed material that you prepare for your LLC and communicate to third parties. In addition, you should generally

refer to your company in conversations with clients, suppliers and others as “my LLC” rather than merely as “my company” or the like. And if your LLC does business under a “DBA” (technically, a trade name with no “LLC” after it), you should make sure this DBA is registered with the New Hampshire Secretary of State as the trade name of the LLC.

Similarly, when signing letters and contracts for your LLC, you should always do so expressly in your legal capacity as an LLC member or manager and not as an individual. Thus, the signature block of LLC contracts should normally be as follows:

XYZ, LLC

By: ____________________
Manager

You may want to depart from the above practices when marketing considerations or other common sense concerns dictate. For example, the initials “LLC” may look out-of-place on a street sign identifying a store that does business as an LLC or in a newspaper advertisement for the store. However, you should be aware that any failure to tell the world that your company is an LLC may create an increased risk of veil piercing.

Guideline 5. IN DEALING WITH THIRD PARTIES, DON’T REFER TO YOUR CO-MEMBERS AS YOUR “PARTNERS”

The personal relationship among the members of multi-member LLCs is often similar to the relationship among the partners of a general partnership. However, under the general partnership law of New Hampshire and all other states, each general partner of a general partnership has unlimited personal liability for claims against the general partnership and against all of the other partners. Thus, if you refer to co-members of your LLC as your partners, this may support a claim by a plaintiff in a lawsuit against you that you have general partner liability.

Thus, if you are a member of a multi-member LLC and you are dealing with customers and other third parties, you shouldn’t refer to the co-owners of your LLC as your partners. Refer to them instead as your co-members.

Guideline 6. MAKE SURE THAT AT THE TIME OF ITS FORMATION AND THEREAFTER, YOUR LLC IS ADEQUATELY CAPITALIZED

A court may be inclined to pierce the veil of an LLC if the LLC lacks adequate capitalization – that is, if its aggregate equity contributions from members, its business assets, its cash flow, its insurance and its other financial resources are inadequate to pay its reasonably foreseeable debts when due. Thus, make sure your LLC is adequately capitalized.

Guideline 7. MAKE SURE YOUR LLC FOLLOWS ALL APPLICABLE FORMALITIES IMPOSED BY THE RELEVANT LLC ACT

Unlike corporate statutes, LLC statutes impose very few formalities on LLCs. For example, LLC statutes do not require LLCs to hold annual meetings of members, and no LLC statute requires LLCs to issue certificates of membership to their members.

However, to the extent that the LLC statute under which an LLC is formed does impose formalities, you should make sure that you comply with these formalities and that you document this compliance.

For example, most LLC statutes, including the New Hampshire LLC Act, contain provisions requiring LLCs to maintain specified types of records (e.g., tax returns and member lists) at a specified LLC office. If your LLC is a New Hampshire LLC, make sure you comply with these provisions.

Has this Newsletter been useful to you? How can I improve it? What other topics should I address in it? Please let me know at lawjmc@comcast.net or give me a call at (603) 228-0125. And feel free to call me at that number if you have any questions about the Newsletter or about other LLC matters.

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 9 (APRIL 2, 2004)

HOW CAN YOUR CLIENTS PROTECT THEIR INVENTORY FROM CREDITORS?

Dear Colleagues:

At this time of year, most tax professionals are deep into tax, and I suspect the last thing you want from a newsletter like this is yet more tax.

So let me share with you in this newsletter a nontax idea – namely, a business law-based method for protecting inventory. You, in turn, may wish to pass this idea on after tax season to those of your clients who, whether as wholesalers or retailers, make their living by sales of inventory. Some of these clients may be very grateful for your words.

By way of background:

Many of us have clients who own businesses that must maintain substantial inventory. If the products that such a client carries in inventory are capable of causing injury and if such an injury occurs, the client's business is likely to be sued, and among the more valuable assets that the business may lose in the suit is its entire inventory. This loss alone could destroy the client's business and foreclose any hope the client may have of starting another business.

> EXAMPLE: XYZ Distribution Company, Inc. is a single-shareholder New Hampshire corporation. It is located in Concord, New Hampshire. Its shareholder is John Doe. XYZ sells auto parts at retail. As a requirement for supplier discounts and to meet customer needs, XYZ must carry a comprehensive parts inventory, whose average daily wholesale value is $500,000. To avoid bank interest and other disadvantages, XYZ self-finances its inventory; but to do so, it must maintain substantial cash.
>
> Needless to say, many types of auto parts routinely sold by XYZ – e.g., brake linings and even batteries - are of such a nature that if they were to malfunction, XYZ could be the subject of a major product liability suit. There is, of course, a good chance that the outcome of the suit would be a judgment against the manufacturer of the part in question, not XYZ. However, you never know what a jury will do. And an adverse judgment against XYZ could, among other things, result in XYZ's losing its entire inventory in a sheriff's sale.

What can John Doe do to protect XYZ's inventory?

As is so often the case in the world of business asset protection, the short answer is that Doe should conduct his business not, as now, through a single entity, but rather, through two entities.

- One entity will be the current XYZ. However, XYZ will now no longer function as a seller, but rather, as a financing company, and Doe will change XYZ's name to XYZ Financing, Inc.

- Doe's second entity will be a newly formed single-member LLC – to be named "XYZ Distribution, LLC" – whose sole member will be XYZ Finance. Under the default rules of the IRS's Check-the-Box Regulations, XYZ Distribution will be a "disregarded entity;" that is, for tax purposes the IRS will deem XYZ Distribution not to exist, and its income will be taxable only to its parent. However, for financial and legal purposes, XYZ Distribution will exist as fully as any other business entity, including XYZ Financing itself.

Once this new structure is in place, here's what will happen:

1) XYZ Financing will sell its current inventory to XYZ Distribution under a promissory note.
2) XYZ will finance any additional inventory that XYZ may ever need under a revolving demand note.
3) XYZ Financing and XYZ Distribution will sign a security agreement. The key provision of the security agreement will be one that provides that the collateral for the above promissory note and revolving demand note will be all of XYZ Distribution's assets. This collateral will include XYZ Distribution's inventory, its cash on hand, its equipment and everything else that isn't subject to a bank lien or other third-party claim.
4) Finally, XYZ Financing will file a "financing statement" – also known as a "UCC-1" – with the New Hampshire Secretary of State. The New Hampshire filing fee will be $10, and the filing will be effective for five years. Filing costs will be minimal: Doe can do the filing in person at 125 Capitol Street or, if he's made the proper financial arrangements, online. The effect of the filing will be to give XYZ a first position in the above collateral as against all other creditors, including any plaintiff who gets a judgment against XYZ Distribution as a result of a product liability suit. Filing costs will be minimal

The above financing arrangements and UCC filing arrangements will provide John Doe with a very strong wall of protection of his inventory against creditors. In effect, these arrangements will turn New Hampshire debtor-creditor law from a potential enemy of John Doe to a friend.

And, as I've already noted, the structuring and implementation of the arrangements will cost Doe only the most modest expenditure of time and government fees and, depending

on the lawyers and accountants he uses, total professional fees that, depending on the specific facts, should be at most several hundred dollars.

Has this Newsletter been useful to you? How can I improve it? What other topics should I address in it? Please let me know at lawjmc@comcast.net or give me a call at (603) 228-0125. And feel free to call me at that number if you have any questions about the Newsletter or about other LLC matters.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 10 (MAY 1, 2004)

HOW TO EXPLAIN CAPITAL ACCOUNTS TO YOUR LLC FORMATION CLIENTS

I. INTRODUCTION

As all CPAs and Enrolled Agents who are subscribers to this newsletter are aware, LLC agreements for multi-member LLCs taxable as partnerships under Subchapter K of the Internal Revenue Code normally should contain a set of provisions relating to capital accounts. These provisions normally should:

- Define the meaning of capital accounts;
- Set forth the rules under Treasury Regulation section 1.704-1(b)(2)(iv) for computing these accounts (the "Capital Account Regulations"):
- Require the LLC to maintain capital accounts in accordance with these rules;
- Require the LLC to make distributions in liquidation of each individual member's partnership interest in such a manner as to leave each of the members after the distribution with a zero capital account; and
- Require the LLC to make liquidating distributions to the members in connection with its own liquidation so as to zero out all members' capital accounts.

Under the Capital Account Regulations, the LLC agreement of such an LLC should state that each member's capital account will be:

5) Increased by the amount of cash contributed to the LLC by the member and by the fair market value of any contributed property (net of liabilities relating to the property that are assumed by the LLC);
6) Increased by LLC allocations of its profits to the member;
7) Decreased by distributions to the member; and
8) Decreased by the member's share of LLC losses.

In my experience, most LLC formation clients don't have the vaguest notion of what capital accounts are all about and why they are important; and many of them are annoyed at the inclusion of what they view as meaningless capital account "tax boilerplate" in their LLC agreements. However, I believe that if they can be helped to understand

capital accounts, this will give them a much deeper practical understanding of their LLC deal.

What, if anything, can we as tax professionals say to these clients to help them gain a practical understanding of capital accounts?

I suggest the 10 points summarized below.

II. WHAT TO TELL YOUR CLIENTS ABOUT LLC CAPITAL ACCOUNTS

1) "Forget about tax" – the primarily *economic* function of capital accounts. First, let's forget about tax for the moment and just think about LLC capital accounts from the viewpoint of common-sense business economics. As I'll discuss later, that's what capital accounts are really all about anyway.

   From a purely economic viewpoint, what the capital accounts of LLC members are designed to accomplish is to divide up the total equity in the LLC (very roughly, its current fair market value) among the members in a manner that reflects their *economic* deal. Broadly speaking, the idea is that if capital accounts are kept accurately, then, if at any given moment the LLC is liquidated and it makes liquidating distributions to its members on the basis of their capital accounts, each member will be assured of getting the member's agreed-upon share of the LLC's value.

   EXAMPLE. On January 1, 2005, Able and Baker form AB, LLC, an LLC taxable as a partnership. Each of them contributes $100, and they agree to share AB's profits, losses and distributions equally. During 2005, AB's net profits are $200. This means that on January 1, 2006, Able's capital account is $200 – the $100 that he originally contributed to AB and his 50% share of AB's $200 of profits. Baker's capital account is, of course, exactly the same. On January 2, 2006, Able and Baker dissolve and liquidate AB. Assuming that AB has no third-party creditors, Able and Baker, in accordance with their original deal, will each receive in this liquidation the $200 reflected in their respective capital accounts.

   In other words, a "zeroing out" of these accounts will ensure that each of Able and Baker receives his agreed-upon share of AB's fair market value upon its liquidation.

2) <u>Capital accounts and "special" allocations and distributions</u>. The importance of maintaining accurate capital accounts should be evident even from the simple example just provided; these capital accounts ensure that when AB is liquidated, Able and Baker will both get the deal they agreed upon.

However, LLCs have a fundamental statutory characteristic that, in many situations, can greatly increase the importance of maintaining accurate capital accounts. Indeed, in the case of many LLCs, this characteristic makes accurate capital accounts an absolute economic necessity; without these accounts, the members can't accomplish their deal.

To explain: A substantial majority of LLCs allocate their profits and losses among their members and their distributions to their members in proportion to their members' shares of aggregate contributions to the LLC.

> <u>EXAMPLE</u>. Jones and Smith form JS, LLC, an LLC taxable as a partnership. Jones contributes $200 to JS. Smith contributes $100. Under JS's operating agreement, JS must allocate two thirds of its profits and losses to Jones and one third to Smith. In addition, whenever it makes a distribution of profits, it must distribute two thirds of the total distributed amount to Jones and one third to Smith.

However, no U.S. LLC act *restricts* LLCs to employing only the above "per-contribution" approach. Instead, all of these acts permit LLCs to make allocations and distributions on a "*per-contract*" basis – i.e., in any way that the members agree in working out their LLC deal. These "per-contract" LLC deals can include agreements among the members under which the allocations and distributions to which they are entitled will be "special" – i.e., disproportionate to their contributions. Furthermore, Internal Revenue Code (IRC) Sections 704(a) and (b) expressly permit and respect "per-contract" arrangements, including "special" allocations and distributions, as long as these arrangements make economic sense and aren't merely tax-motivated.

> <u>EXAMPLE</u>. Barbara Jones forms BJ, LLC, and contributes $100 to it. A year later, she has a desperate need for additional capital and asks John Smith to contribute $100 in exchange for a membership in BJ. Smith agrees, but only on the condition that Smith be entitled to two thirds of all BJ profits after the date of his contribution. In other words, John Smith wants a "special" allocation that will be disproportionate to his share of aggregate contributions. Obviously, Jones doesn't like this deal. However, because Smith is the only person she has found who is willing to invest in BJ, and because she needs his investment in order to save her company, she has no choice but to accept his terms.

However, in a situation in which Jones and Smith will have equal contributions but unequal allocations, there is only one safe way to make sure that upon any liquidation of either (i) the LLC interests of Jones or Smith or (ii) BJ, LLC itself, the economics of the deal between Jones and Smith will be enforced. This is for BJ to maintain separate and accurate current capital accounts for each of Jones and Smith.

The necessity for capital accounts becomes even more evident if, as part of the deal between Jones and Smith, Smith agrees as follows:

- Although BJ will allocate two thirds of its profits to him, it will make no distributions to him until his LLC interest is liquidated or BJ itself is liquidated.

- By contrast, all amounts that BJ allocates to Jones will be immediately distributed to her.

The net effect of the above agreements will probably be that if BJ is profitable, then, when the time comes to liquidate BJ, Smith will have a substantial capital account and the zeroing out of his capital account will result in a substantial liquidating distribution to him; whereas Jones' capital account and thus her liquidating distribution will be quite small (and will perhaps even be zero).

3) <u>Comparing capital accounts and bank accounts</u>. As a good starting point for understanding your capital account as an LLC member (but *only* as a starting point), think of your capital account as bearing roughly the same relation to your LLC as your bank account bears to your bank. Your bank account at any given moment consists of your deposits (roughly comparable to your contributions to your LLC and your allocations of LLC profits) less your withdrawals (roughly comparable to your distributions from your LLC and your share of LLC losses). Needless to say, this analogy limps, since banks, unlike LLCs, don't allocate their profits or losses to their depositors, nor do they distribute bank profits to them. But the analogy is helpful nonetheless when you're trying to get a basic initial understanding of capital accounts.

4) <u>Discrepancies between capital accounts and economic reality</u>. In the real world, the total capital accounts of all of the members at any given moment usually won't exactly reflect the actual fair market value of the LLC at that moment. This is because the aggregate fair market value of the assets of virtually any LLC is likely to fluctuate to a significant degree from quarter to quarter or even from day to day. Thus, at times, this value may be much higher than the aggregate dollar value of the members' capital accounts; at other times, it may be much less.

5) "<u>Revaluations</u>." However, in five main situations, the Capital Account Regulations let the members "revalue" the LLC's assets and thus the members' capital accounts so as to reflect the LLC's actual fair market value. These revaluations are also frequently referred to as "book-ups" (if the value of the assets is increased in the revaluation) and "book-downs" (if this value is decreased). For certain of these revaluations, the IRS requires that the LLC have a special election in place. See, e.g., Capital Account Regulations, Sections 1.704-1(b)(2)(iv)(d)(1) and (1)(b)(2)(iv)(f).

    a) <u>LLC buy-out of a member</u>. The first situation is when the LLC buys out a member. (In tax terms, an LLC's buy-out of a member is a "liquidation of the member's interest." In legal terms, it is a "redemption" of this interest.) At that time, the members will presumably negotiate together at arm's length to arrive at an economically acceptable buy-out price. This price, in turn, will be based on

the actual fair market value of all of the LLC's assets. In connection with the buy-out, the Capital Account Regulations will permit the LLC to revalue its aggregate assets, and, correspondingly, its members' shares of this value as reflected in their capital accounts.

b) Liquidation of LLC. The second situation when the IRS permits revaluations is when the LLC itself is liquidated. In this situation, the actual fair market value of the LLC's aggregate assets is likely to be even clearer than in the first situation, since the sale of these assets in connection with the LLC's liquidation will fix this value once and for all and thus will definitively determine the final economics of the LLC deal.

c) LLC admission of a new member. The third situation is when the LLC permits a new member to buy into it. Here, too, the price at which the new member purchases that member's membership will usually reflect the fair market value of the LLC and thus will justify any necessary revaluation of its assets and thus of the members' capital accounts.

d) Increase of existing member's interest through new contribution. The fourth situation is when the LLC permits an existing member to increase the member's share in the LLC by contributing new money or property. An example would be where the LLC needs more money and a member agrees to contribute it, but only if the member's share of LLC profits is duly increased.

e) LLC holds only securities. The fifth is when substantially all of the LLC's non-cash assets are stocks, securities, options, and other similar assets that are traded on a national exchange (e.g., the New York Stock Exchange or the Chicago Board of Trade). Obviously, the fair market value of these securities is crystal-clear on a day-by-day basis. In this situation, the IRS lets the capital accounts of the LLC's members be periodically updated in accordance with generally accepted accounting principles ("GAAP").

f) Admissions of service partners. Finally, the U.S. Treasury Department has recently issued final regulations permitting revaluations of partnership assets upon the admission of service partners – i.e., partners that will be permitted to participate in partnership profits without making contributions to partnership capital. Obviously, the non-service partners will want these revaluations in order to lock in their respective shares of the partnership's value up to the date of the service partner's admission.

6) An anomaly under the Capital Account Regulations - sales of LLC interests by the members. Somewhat anomalously, the Capital Account Regulations do not permit revaluations of LLC assets when existing members sell their memberships to other members or to third parties. However, as indicated above, even though the purchaser's capital account may not reflect the economic reality of its value at the moment of purchase, this discrepancy will eventually be eliminated upon the new member's redemption or upon the LLC's own liquidation.

7) Why don't C and S corporations have to maintain capital accounts for their shareholders? Upon hearing the above discussion of LLC capital accounts, my LLC

formation clients sometimes ask me why LLCs have to maintain capital accounts for their members, whereas corporations (and indeed, LLCs) taxable under Subchapter C or S do not.

The reason is that, not only because of economics but also because of corporate law requirements, all allocations and distributions by state law business corporations, whether they are C or S corporations, must be on a pure per-share basis. Thus, these corporations can never have the kind of temporary disconnect between contributions, allocations and distributions that LLCs can often have. By contrast, LLCs taxable as partnerships may (as discussed above) allocate their profits, losses and distributions not only on a "per-contribution" or "per-share" basis but also on a "per-contract" basis that provides for "special" allocations and distributions. These special allocations and distributions can only be kept track of with accurate capital accounts, and LLC deals in this situation can only be fair in liquidation situations if these accounts are zeroed out. Per-contribution and per-share allocations of an LLC's values can be done by simple division. Per-contract allocations, by contrast, requiring painstaking additions to capital accounts and subtractions from them; you can't do the trick by mere division.

8) <u>The primary importance of capital accounts is economic</u>. The above is a brief discussion of the economic reasons for capital accounts. I hope this discussion will make it clear that even if the IRS didn't require your LLC to maintain a capital account for each of your members, you would want the LLC to do so in order to ensure that the members get the economic deal they bargained for.

9) <u>Why does the IRS care about capital accounts</u>? Why, though, should the IRS even *care* about economic justice among the members? After all, the IRS is interested in tax, not economics. The reason for the IRS's concerns about LLC economics is that, for all the daunting complexity of partnership federal income taxation, the ultimate purpose of partnership tax rules is simple – namely, to ensure that in the end, arm's-length economics, and not tax, governs partnership allocations and distributions. The way the IRS seeks to enforce this purpose is essentially (i) by requiring partnerships to maintain sound capital accounts for their members; and (ii) by using these accounts as the basis for partner and partnership liquidations.

10) <u>Conclusion</u>. When it comes to partnerships, the IRS wants to ensure that no matter what may happen on an interim basis within a partnership (including an LLC taxable as a partnership), in the end, economics will trump tax in the case of each partner (and LLC member). Capital accounts are the IRS's tools for obtaining this outcome.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 11 (JUNE 1, 2004)

DO YOUR CLIENTS' LLCs NEED FIXING?

Part I – INTRODUCTION AND SUMMARY

Introduction.

There are now about 23,000 New Hampshire LLCs (as compared with about 25,000 New Hampshire corporations). Half of these LLCs have only a single member. Most of the rest have two members. A small number have three or more members.

Over the past 10 years I have dealt with hundreds of LLCs that have been formed by their own members or by lawyers who lack significant LLC expertise. On the basis of this experience, I believe that as many as half of all New Hampshire LLCs – in other words, a good 11,500 of them - have potentially serious legal or tax flaws that need repair. If any of them are owned by clients of yours, you can do these clients an important service by pointing out the flaws in their LLCs and making sure these flaws get fixed.

In this issue of my newsletter, I'll list the 13 principal errors that, in my experience, people who lack LLC tax and legal expertise are likely to make in forming LLCs. In the following two issues, I'll discuss these errors in greater detail and I'll explain how to repair them.

Forming LLCs – the Top 13 Errors

You're not an accountant or a lawyer, but a few months ago, you decided to form an LLC on your own without professional help. When you did so, what are the main errors you were likely to have made?

SINGLE-MEMBER LLCs (ERRORS 1-8)

1) Single- or multi-member LLC – failure to address veil-piercing and asset protection. You formed a single- or multi-member LLC, but you failed to take basic measures to protect your LLC liability shield and to maximize LLC statutory asset protection. (Needless to say, people who have formed a multi-member LLC can make this same error.)
2) Too few entities. You formed a single-member LLC, but to maximize business asset protection, you should have formed two of them. (Needless to say, people who have formed a multi-member LLC can make this same error.)

3) Single-member LLC – too few members for business effectiveness. You formed a single-member LLC, but, in order to maximize business effectiveness, you should have formed a multi-member LLC.

4) Single-member LLC – too few members to provide business asset protection. You formed a single-member LLC, but, in order to obtain business asset protection, you should have formed a multi-member LLC.

5) Single-member LLC – too few members to avoid Social Security taxes. You formed a single-member LLC, but, in order to minimize Social Security taxes, you should have formed a multi-member LLC.

6) Single-member LLC – failure to make S election. You formed a single-member LLC, but when you did so, you should have made an S election to minimize Social Security taxes.

7) Single-member LLC – failure to consider Interest and Dividends Tax problems. You formed a single-member LLC, but in order to avoid the New Hampshire Interest and Dividends Tax, you should have formed a two-member LLC.

8) Single-member LLC – failure to adopt LLC agreement. You formed a single-member LLC, but your LLC has no written LLC agreement.

MULTI-MEMBER LLCs (ERRORS 9-13)

9) Multi-member LLC – partnership – failure to address federal income tax problems. You formed a multi-member LLC taxable as a partnership, but you failed to structure it to avoid partnership federal income tax problems.

10) Multi-member LLC – partnership – failure to address Social Security tax problems. You formed a multi-member LLC taxable as a partnership, but you failed to structure it to minimize Social Security taxes.

11) Multi-member LLC – failure to address I&D Tax problems. You formed a multi-member LLC, but you failed to structure it to protect the members from the New Hampshire Interest and Dividends Tax.

12) Multi-member LLC – failure to make S election. You formed a multi-member LLC, but, in order to minimize Social Security taxes, you should have made an S election for it.

13) Multi-member LLC – failure to adopt LLC agreement. You formed a multi-member LLC, but you and your co-members failed to negotiate and sign an LLC agreement.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 12 (JULY 6, 2004)

DO YOUR CLIENTS' LLCs NEED FIXING?

PART II – EIGHT COMMON MISTAKES IN FORMING SINGLE-MEMBER LLCS

INTRODUCTION

There are currently about 23,000 New Hampshire LLCs. Most of these LLCs have been formed by their owners without the assistance of a lawyer, accountant or other professional with LLC expertise. In the June 2004 issue of this newsletter, I listed and briefly described the main mistakes that that these owners often making in forming single-member and multi-member LLCs.

Of the above 23,000 LLCs, about half are single-member LLCs. In this issue of the newsletter, I'll discuss in greater detail

- The eight biggest mistakes that "John Doe" and "Mary Roe," hypothetical LLC owners who lack LLC expertise, are likely to make in forming single-member LLCs; and

- What John and Mary should do to fix these mistakes.

In the next issue, I'll discuss the mistakes that John and Mary are likely to make in forming multi-member LLCs.

EIGHT COMMON MISTAKES IN FORMING SINGLE-MEMBER LLCS

MISTAKE # 1 - FAILURE TO ADDRESS VEIL-PIERCING ISSUES

Whenever business founders form new businesses, they should implement right from the start all of the various anti-veil piercing measures they will need in order to ensure that if they are ever sued, their personal assets will be protected. Extensive guidelines for preventing veil piercing are set forth in the "FAQ" section of my website. Please visit www.llcformations.com to access these guidelines.

> EXAMPLE 1. John Doe sets up "John Doe, Esq. and Associates, P.L.L.C.," a single-member professional LLC, to conduct a solo law practice. However, in conducting his practice, John does not maintain his professional books and records separately from his personal books and records, and his business card says only "John Doe, Esq.," not "John Doe, Esq., P.L.L.C." If John's P.L.L.C. is ever sued for malpractice because of something one of his associates or co-members

does, his P.L.L.C. will face a significant risk of veil piercing.

MISTAKE # 2 - FORMING ONLY ONE LLC FOR A BUSINESS THAT WILL HAVE SIGNIFICANT BUSINESS ASSETS

Whenever business founders are starting new businesses that, at the time of their formation or reasonably soon thereafter, will have valuable business assets, the founders shouldn't just form one LLC to conduct these businesses; they should form two. One of these businesses should conduct the founder's actual business operations. The other should hold most or all of the founder's business assets and should loan, lease or license these assets to the operating LLC. If founders use this two-entity arrangement and if their operation entities are ever sued, this arrangement should protect them from losing their business assets in the suit.

> EXAMPLE 2. Mary Roe is starting a new widget manufacturing company in New Hampshire. The company will own its name ("Cosmic Widgets"); it may eventually own trademarks associated with the name; it will own a website (www.cosmicwidgets.com); and it will own various manufacturing equipment and miscellaneous other assets. In addition, Mary expects that her business will eventually maintain operating capital of about $100,000.
>
> When Mary forms her business, she should form a single-member LLC, of which she will be the owner; and she should form a second entity that will hold all of its assets. The second entity will license her business name, her website, her trademarks and all other intellectual property that she owns to her operating entity; it will lease all of her hard assets to her operating entity; and it will loan to the operating entity all of the operating cash that it will need. The loan will be secured by all of the operating entity's assets, and this security interest will be "perfected" by a UCC-1 filed with the New Hampshire Secretary of State.

MISTAKE # 3 - FORMING AN ENTITY AS A SINGLE-MEMBER LLC THAT NEEDS THE SYNERGIES THAT MULTIPLE MEMBERS CAN PROVIDE

Multi-member LLCs are usually much more complicated and expensive to form than single-member LLCs. However, there are also many situations in which businesses that lack the synergies afforded by multiple members will fail. Before business founders form single-member LLCs to conduct their businesses, they should first ask themselves whether they will need these synergies. If the answer is yes, they should consider forming their LLCs as multi-member LLCs, not single-member LLCs.

> EXAMPLE 3. John Doe, an engineer, is starting a manufacturing company, in which he plans to invest his life savings and the proceeds from a second mortgage on his home – total start-up capital of $300,000. However, if he were to do the numbers, he would realize that before his company becomes profitable, he will

need business capital of at least $400,000. But until he has a significant track record, he probably won't be able to borrow the extra $100,000 that he needs. Instead, he will need one or more equity investors as co-members of his LLC – i.e., he will need to form his LLC as a multi-member LLC. Otherwise, he may as well give up before he starts.

MISTAKE # 4 - FORMING A SINGLE-MEMBER LLC THAT SHOULD HAVE TWO MEMBERS IN ORDER TO PROTECT ITS BUSINESS ASSETS

As I've discussed in other issues of this newsletter, both LLC legal theory and a famous LLC case called In re: *Ashley Albright* make clear that if you want to protect your business assets from claims brought against you by third parties in your personal capacity, you need to hold these assets not in a single-member LLC but in an LLC with at least two members.

EXAMPLE 4. Mary Roe forms an operating LLC to manufacture widgets and a leasing LLC that holds $200,000 worth of manufacturing equipment, which it leases to her operating entity. However, the only member of Mary's leasing LLC is Mary herself. A year after starting her business, Mary, while driving her car on personal business, accidentally but negligently runs over and kills a brain surgeon and incurs a judgment of $2,000,000. Her auto insurance coverage per incident is capped at $1,000,000. Because Mary is the sole owner of her leasing LLC, a judge orders the sale of her business assets in satisfaction of the judgment against her by the surgeon's estate. If Mary had had a co-member of her leasing LLC, she could have protected her equipment from her creditor.

MISTAKE # 5 - FAILURE TO MINIMIZE SOCIAL SECURITY TAXES BY ADMITTING A SECOND MEMBER

The default federal income taxation of single-member LLCs owned by individuals is sole proprietorship taxation. Individuals subject to sole proprietorship taxation pay full-freight Social Security taxes. Individuals who form new businesses and want to minimize Social Security taxes often choose to admit a second member - for example, their spouse - and to structure their LLC in accordance with Social Security tax avoidance guidelines set forth in an Internal Revenue Service regulation called Prop. Reg. §1.1402(a)-2.

EXAMPLE 5. John Doe forms a single-member LLC to providing trucking services. He contributes to the LLC three trucks with a fair market value of $200,000. Under applicable IRS rules, his LLC is taxable as a sole proprietorship, and John pays Social Security taxes on all of his LLC's earnings. If John had admitted his wife as a 20-percent co-member and adopted a properly

drafted LLC agreement, he could be saving thousands of dollars of Social Security taxes every year.

MISTAKE # 6 - FAILURE TO MINIMIZE SOCIAL SECURITY TAXES BY MAKING AN S ELECTION

For most individuals who own single-member LLCs, the best federal income tax regimen is that of a sole proprietor. However, occasionally, such an individual can save substantial Social Security taxes by electing to have his or her LLC taxable as an S corporation. This can happen, for example, if capital investment or employees other than the business owner will be significant income-generating factors in the owner's business.

> EXAMPLE 6. Mary Roe is forming a single-member LLC to manufacture widgets. Right from the start, her company will have $500,000 worth of manufacturing equipment and five employees in addition to Mary. In this situation, Mary should consider making an S election for her LLC and paying herself a relatively low salary of, say, $35,000. (After all, this is a risky start-up that can't afford high salaries anyway.) Mary's S election could save her thousands of dollars a year in Social Security taxes.

(Note: Whether the founder of a new business should save Social Security taxes by (i) admitting a second member and using Prop. Reg. §1.1402(a)-2 or (ii) keeping the founder's LLC as a single-member LLC and making an S election is a complex matter. I will address it in a subsequent newsletter.)

MISTAKE # 7 - FAILURE TO CONSIDER INTEREST AND DIVIDENDS TAX ISSUES RAISED BY SINGLE-MEMBER LLCs

Under the New Hampshire Interest and Dividends Tax, New Hampshire residents who receive distributions from LLCs that have non-transferable management rights are not subject to that tax. It is clear that the members of a multi-member LLC can avoid the I&D Tax as long as their LLC agreement provides that no member may transfer his or her management rights without the consent of other members. Whether it is possible for the members of single-member LLCs to avoid the I&D Tax is less clear. (Personally, I think that no member of a single-member LLC should ever be liable for the I&D Tax, but there are reasonable grounds on which the New Hampshire Department of Revenue Administration can argue otherwise.)

> EXAMPLE 7. John Doe forms a single-member LLC to conduct his widget manufacturing business. The business thrives and eventually John leaves its operations to hired managers and spends all his time polishing his golf game. The LLC makes annual distributions of profits to John of $200,000. The DRA eventually audits John's LLC and assesses a delinquency of five percent of

$600,000 plus interest and penalties – a total of over $50,000. Maybe John can beat the DRA in this case; but if he had had a minor co-member of his LLC during the tax years in question, the problem could never have arisen.

MISTAKE # 8 - FAILURE TO ADOPT A WRITTEN LLC AGREEMENT

The New Hampshire Limited Liability Company Act was originally drafted and adopted in 1993 on the assumption that all LLCs would have at least two members. In 1997, it was amended to provide for single-member LLCs, and these amendments adapted it in various ways to address the special issues of single-member LLCs.

However, there are still many provisions of the Act that simply don't work for single-member LLCs. For this and other important reasons, anyone who forms a single-member LLC and can afford to pay a lawyer to draft an LLC agreement for it should do so. (From what I hear, the typical fee for this service in New Hampshire is very roughly $700.)

EXAMPLE 8. On January 1, 2000, Mary Roe forms a single-member LLC to conduct her financial planning business. She never adopts an LLC agreement for it. Under the default rules of the New Hampshire Limited Liability Company Act, her LLC is "member-managed;" this means that only Mary has the legal authority to manage it. The business does excellently. Tragically, however, on January 1, 2004, Mary suffers a stroke that will incapacitate her for at least a year. Because Mary's LLC is member-managed, neither her husband nor anyone else can pay Mary's LLC's receivables or deposit its receipts in the bank or handle other critical business functions for it during Mary's illness. This results in severe financial hardships for Mary and her family.

If Mary had formed her LLC as a manager-managed LLC and had adopted an LLC agreement in which she appointed her husband as assistant manager with authority to act as manager in the event of her death or disability, all of these hardships would have been avoided.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 13 (AUGUST 4, 2004)

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:

- IRC Section 704(c)(1)(A) – the precontribution gain rule. 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.

- Liquidation in accordance with capital accounts. 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.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 14 (SEPTEMBER 3, 2004)

BUSINESS ENTITY RESTRUCTURING – FIVE QUESTIONS YOU SHOULD ASK ABOUT YOUR CLIENTS' BUSINESS STRUCTURES

I. INTRODUCTION

Accountants and other tax professionals should never take it for granted that either their new business clients or their existing ones have the right business entity structure. These professionals can often render an important service to their clients by questioning their current structure, pointing out any flaws that may exist in it, and making suggestions on how to correct these flaws. This process is one that, in my experience, many tax professionals neglect. However, it can be a substantial source of professional income.

In reviewing their clients' structures, tax professionals should ask five main questions. Set forth below are each of these questions and brief comments on each.

II. THE FIVE QUESTIONS

1) Number of Entities. Does the client's structure include the right number of entities?

   a) The Classic Holding Company/Operating Company Structure. As a general rule, any company that has valuable business assets should hold these assets in an essentially passive holding company and should conduct all of its operations in a separate operating company. Since it is almost always the operations of a company, and not the mere holding of assets, that will attract lawsuits, this holding company/operating company structure will provide a company's assets with strong legal protection.

   b) The Parent/Subsidiary Structure.

      i) The simplest and usually the best holding company/operating company structure is that of (i) parent company as holding company; and (ii) wholly owned subsidiary as operating company.

      ii) However, it is sometimes wise for a company to conduct its operations not in a subsidiary, but rather, in a freestanding sister company, and sometimes it may even be wise for this sister company to have a somewhat different set of owners than the "parent" company.

   c) The Parent/Subsidiary I&D Tax Problem. If the parent company in the above holding company/operating company structure is a business corporation under state law, this will create a problem under the New Hampshire Interest and Dividends Tax (the "I&D Tax") "on distributions from the operating company to

its parent. I will discuss the solution to this problem in detail in next month's newsletter.

However, briefly, the solution is to make the operating company a two-member LLC, of which one member is the parent itself and the other is a separate single-member LLC federally taxable as a disregarded entity. This arrangement will protect the parent from the I&D Tax.

2) Business Organization Form. Does each of the client's entities have the right business organization form?

   a) The Seven New Hampshire Business Organization Forms. Under New Hampshire law, there are seven main business organization forms – (i) sole proprietorships, (ii) divisions, (iii) traditional general partnerships, (iv) general partnerships that elect to be limited liability partnerships ("LLPs"), (v) limited partnerships, (vi) business corporations and (vii) LLCs.

   b) The LLC Business Organization Form Is Almost Always the Best Form for New Hampshire Companies. For reasons I've discussed extensively in previous issues of this newsletter (and which you can review further by visiting www.llcformations.com), the LLC business organization form is almost always the only right form for New Hampshire business entities, whether they are parent companies, wholly owned subsidiaries, or sister companies.

   c) Should New Hampshire Business Corporations Convert to LLCs? When should companies that are state-law business corporations convert to LLCs? Obviously, the answer depends on the facts, but the short answer is "usually." The reason is, above all, that LLCs offer unique business asset protection advantages and other advantages under Section 47 of the New Hampshire Limited Liability Company Act that business corporations cannot offer. However, another major reason for converting business corporations to LLCs is to avoid the I&D Tax.

   d) Tax Risks in Conversions. If your client converts its business corporation to an LLC, will this involve federal income tax risks? The short answer is no; the conversion will be a tax-free F reorganization under Internal Revenue Code Section 368(a)(1)(F).

   e) Can Your Client Lose Its S Election in a Conversion? If your client converts its business corporation to an LLC and the business corporation was an S corporation, will it preserve its S election? The short answer is yes, as evidenced by numerous IRS private letter rulings.

   f) Using the LLP Form. If the client's company is a general partnership, the simplest way to protect its owners from personal liability for company debt is to convert the partnership to a New Hampshire LLP. However, for most New Hampshire general partnerships, a conversion to an LLC, while more complicated, will also be much better. This is because LLCs provide Section 47 protections and general partnerships do not.

3) Federal Tax Structure. Does each of the client's entities have the right federal tax structure?

The issue of which federal tax regimen is likely to be best for a particular company is very complex. The issue is addressed at length in www.llcformations.com. In my experience, as many as one half of all New Hampshire companies have the wrong federal tax structure.

4) State Tax Structure. Does each of the client's entities have the right state tax structure?

   As all New Hampshire tax professionals know, the New Hampshire Business Profits Tax ("BPT") is hard to avoid except by (i) comping out or (ii) using multiple entities to avoid the $50,000 BPT floor. And the New Hampshire Business Enterprise Tax can be even harder to avoid. However, by the use of LLCs, owners of New Hampshire business entities can entirely avoid I&D Taxes which they cannot avoid if their entities are corporations. For profitable companies with major owners in New Hampshire, the use of LLCs can result in very substantial I&D Tax savings.

5) Owner Agreement. Does the client's business have an appropriate written agreement among its owners?

   a) What ownership agreements should do. The owner agreement of an entity should define:

      i) The entity's internal financial arrangements (consisting mainly of arrangements concerning contributions, allocations, distributions, owner compensation for services and buy-sells);

      ii) The entity's management structure;

      iii) Its tax structure;

      iv) Its fiduciary structure;

      v) Its dissolution; and

      vi) Its dispute resolution structure.

      To avoid owner disputes, the agreement should always be in writing.

   b) Single-member LLCs Need LLC Agreements. Because of potentially troublesome peculiarities in the New Hampshire Limited Liability Company Act, every single-member LLC should have an LLC agreement between its owner and itself. The LLC agreement will protect the owner from these peculiarities.

   c) Which Multi-owner Companies Need Owner Agreements? Any multi-owner company whose business involves or will eventually involve substantial financial stakes needs an agreement among its owners that defines (i) the nature of their company and (ii) their own respective rights and duties as owners.

   d) The Shocking Facts about Owner Agreements. However, my experience is this:

      i) A shocking number of New Hampshire multi-owner companies have no ownership agreement at all.

ii) The New Hampshire companies that do have these agreements often have agreements that fail to address fundamental ownership issues or that address them wrongly.

III. CONCLUSION

Never assume that the business entity structure of your new or existing business clients is the right structure. Ask the above five questions about the business entity structure of each of your clients. If the answers aren't satisfactory, warn your clients and tell them how to fix their problems.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 15 (October 2, 2004)

CONVERTING NEW HAMPSHIRE BUSINESS CORPORATIONS TO LLCS – A FEDERAL INCOME TAX DISASTER?

There are two strong reasons why New Hampshire business corporations should consider converting to New Hampshire limited liability companies under the New Hampshire Limited Liability Company Act (the "LLC Act"):

1. Charging order protections. Under the "charging order provisions" of Section 47 of the LLC Act, multi-member LLCs provide asset protection. For many closely held New Hampshire corporations, this "charging order" asset protection is crucial. Corporations cannot provide it. (For more information about LLC charging order protections, visit www.llcformations.com; click on the FAQ tab; and click on the links for Questions 3.1 and 3.6.)

2. Avoidance of I&D Tax. Under Section 77:4,III of the New Hampshire Interest and Dividends Tax, distributions to members of New Hampshire multi-member LLCs who reside in New Hampshire are exempt from the New Hampshire Interest and Dividends Tax in the hands of the distributees. Distributions from corporations to these distributees are not exempt from the I&D Tax.

However, what if a New Hampshire business corporation has substantial built-in gain? If it converts to an LLC, won't this be a "deemed dissolution" for federal income tax purposes and thus trigger a huge tax? If this is so, then why would any New Hampshire corporation with built-in gain ever convert?

The short answer is that if it's done correctly, the conversion of a New Hampshire business corporation to an LLC is a tax-free F reorganization under Internal Revenue Code Section 368(a)(1)(F), since it is a "mere change in. . . form [involving] a single corporation."

In order for such a conversion to qualify as an F reorganization, Section 368(a)(1)(F) itself and related federal tax authorities require that the conversion meet each of six tests. If you do the conversion correctly, all of these tests will be easy to meet. The six tests, with my brief comments on each in *italic text* in parentheses, are as follows:

1) Change of business organization form. Under the terms of Section 368(a)(1)(F) as interpreted by relevant revenue rulings and PLRs, the conversion transaction must involve a change in either name, business organization form or place of organization. *(Obviously, the conversion of a business corporation to an LLC involves a change of business organization form from that of a business corporation to that of an LLC.)*

2) “Mere” change of business organization form. Under the terms of Section 368(a)(1)(F), the transaction must involve a “mere” change of business organization form. The Section 368(a)(1)(F) word “mere” is defined in case law and in new proposed regulations under Sections 368(a)(1)(E) and (F) issued by the Internal Revenue Service on August 12, 2004. These proposed regs impose a four-part test for qualifying as a “mere” change of form. *(As you’ll see if you read the new proposed regulations, all of these tests can be easily met by a New Hampshire business corporation converting to an LLC.)*

3) Single corporation. Under the terms of Section 368(a)(1)(F), the transaction must involve only a single corporation. The relevant legislative history makes clear that this means that no separate corporation may be involved in the conversion transaction. *(Obviously, the conversion of a New Hampshire business corporation to an LLC will rarely, if ever, involve another corporation.)*

4) Business purpose. Under the Internal Revenue Code Section 368 regulations, the conversion transaction, like all transactions qualifying for tax-free treatment under Section 368, must have a business purpose, and this purpose must benefit the entity in question and not merely its shareholders. *(In my view, it is very clear that doing a conversion in order to obtain Section 47 benefits easily meets this test.)*

5) Plan of reorganization. Under the Section 368 regulations, the transaction must be carried out in accordance with a “plan of reorganization.” *(The relevant regulations are unclear as to the precise meaning of a “plan of reorganization,” but it’s clear that the conversion of a New Hampshire corporation to an LLC will be “pursuant” to such a plan if the plan exists in writing before the implementation of the conversion and if it spells out in reasonable detail the basic facts relating to the conversion, including its purpose and method of implementation.)*

6) Filing of Internal Revenue Service Form 8832. Under the Check-the-Box Regulations and numerous PLRs, before the conversion, the shareholders of the corporation in question must consent to the corporation’s filing an election under Internal Revenue Service Form 8832 to be taxable as an association taxable as a corporation, and immediately after the conversion, the new LLC must in fact file this form. *(Obviously, merely filing a simple one-page form with the IRS is hardly too much to ask in order to qualify as an F reorganization.)*

In short, if you’re helping your client to convert its business corporation to an LLC in order to avoid the I&D Tax or obtain Section 47 protections, qualifying the conversion as an F reorganization should be a piece of cake.

But what if, as often happens, the business corporation that wants to make a conversion to LLC owns real property? Is the conversion a deemed transfer of that property that will trigger the New Hampshire Real Estate Transfer Tax?

In my view, the answer is no. In next month’s newsletter, I’ll explain why.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 16 (November 8, 2004)

IF YOU CONVERT YOUR BUSINESS CORPORATION TO AN LLC, WILL YOU LOSE YOUR S ELECTION?

As I wrote in last month's newsletter, there are two strong reasons why New Hampshire business corporations should consider converting to New Hampshire limited liability companies under the New Hampshire Limited Liability Company Act (the "LLC Act"):

1. Charging order protections. Under the "charging order" provisions of Section 47 of the LLC Act, multi-member LLCs provide business assets and other key protections that no corporate statute, including the New Hampshire Business Corporation Act, can provide. For many closely held New Hampshire corporations, these "charging order" protections can provide crucial legal advantages. (For more information about LLC charging order protections, visit www.llcformations.com; click on the FAQ tab; and click on the links for Questions 3.1 and 3.6.)

2. Avoidance of I&D Tax. Under Section 77:4,III of the New Hampshire Interest and Dividends Tax, New Hampshire residents who are members of multi-member LLCs are exempt from that tax as long as the LLCs have "nontransferable shares" (something which is easily provided for in a properly drafted LLC operating agreement). Distributions from business corporations to these distributees are subject to the I&D Tax - and this is true *whether or not* these corporations have nontransferable shares.

In last month's newsletter, I stated what I believe is a compelling case that the conversion of a New Hampshire business corporation to an LLC is an "F reorganization" under Internal Revenue Code Section 368(a)(1)(F) and thus cannot trigger any federal income tax either to the shareholders of the corporation or to the corporation itself. In other words, by reason of Section 368(a)(1)(F), the IRS will not treat the conversion as a sale of corporate stock or assets.

However, many New Hampshire corporations, including some very large ones, have made S elections, and the status of these corporations as S corporations is extremely important to their shareholders as a protection against double taxation in the event of an asset sale (and in various other situations).

Hence the importance of the following question: If a New Hampshire business corporation that is an S corporation converts to an LLC, will this conversion have any adverse effect on its S election? More particularly, will the conversion affect the effective date of its S election?

I'm happy to be able to tell you that, assuming that after the conversion, the former business corporation (now an LLC) files Internal Revenue Service Form 8832 and checks Box 2a of that form to elect to be an "association taxable as a corporation," the answer will be a resounding "no."

The basic reason for this answer is rooted in the theory underlying Section 368(a)(1)(F). As you'll recall, in a reorganization under Section 368(a)(1)(F), a corporation merely changes its name, business organization form or place of incorporation. When it does so, it is the same entity and, for all federal tax purposes, it is the same "tax corporation" after the change as before.

This means, in particular, that none of its tax attributes change – including its S election. This tax theory was reflected 40 years ago in a famous IRS revenue ruling known as Rev. Rul. 64-250. Rev. Rul. 64-250 has been followed in dozens of subsequent IRS administrative rulings.

The most recent such ruling is PLR 200248023, in which the IRS has ruled, among other things, that when an entity that was a business corporation and had an S election merged into an LLC in a reincorporation transaction, the entity in its new business organization form as an LLC would retain its S election and the effective date of this election would be unchanged as long as the entity, after the merger, filed the above IRS Form 8832.

The bottom line: If clients of yours who own a business corporation want to update their business organization form, avoid I&D Tax and enhance their business asset protection by converting to an LLC, they can rest assured that this conversion will have no effect whatsoever on their S election.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 17 (March 2, 2005)

RESTRUCTURING YOUR CLIENTS' BUSINESSES TO AVOID THE BUSINESS PROFITS TAX

Under Section 6,I of the New Hampshire Business Profits Tax Act, RSA 77-A:6,I:

> Every business organization having gross business income in excess of $50,000 during the taxable period shall . . . make a return to the commissioner [of the Department of Revenue Administration].

The rule contained in this BPT section (which I'll call the "$50,000 Rule") is well known to those of us who hold ourselves out as New Hampshire tax professionals.

However, not all of us are as alert as we should be to the tax-saving possibilities inherent in the $50,000 Rule. To illustrate these possibilities:

> Jane Roe is the owner of a single-member LLC called "Jane's Place." Jane reports the income of her company on Schedule C. Her company owns a parcel of New Hampshire land and the buildings located on it, consisting of a service station and a convenience store. The land and buildings are worth $300,000. Jane's Place also owns service station and convenience store tools, equipment, vehicles and inventory (including, for example, food and gasoline) worth about $150,000. Jane usually keeps about $50,000 in cash in the bank account of her company as operating capital. (In keeping with the usual legal practice, I'll refer to the non-real property business assets of Jane's Place as its "personal property.") Jane's Place uses its real and personal property to conduct a highly profitable service station and convenience store business.
>
> However, Jane is semi-retired and works for Jane's Place for only about 10 hours a week. Thus, her accountant has advised her that for BPT purposes, she can't safely deduct more than $20,000 a year as compensation for her services to Jane's Place. The result of this and other factors is that every year, Jane's Place has taxable business profits of about $100,000 and an annual BPT tab of about $8,500.

What should Jane do if she wants to reduce or eliminate her BPT liability?

Here's what she should do:

- She should transform Jane's Place from an operating business into a real estate holding company.

- She should distribute the name "Jane's Place" and all of the other personal property owned by her real estate holding company to herself. (Because, from a federal income tax viewpoint, Jane's Place is a sole proprietorship, she can make these distributions on a tax-deferred basis.)
- She should form a new LLC to serve as her personal property holding company, and she should contribute all of her personal property to this company. To avoid Social Security tax on its rental income, Jane's personal property holding company should make an S election when it is formed.
- She should form a new single-member LLC to operate her business. To protect Jane from Social Security tax, this LLC, too, should make an S election.
- She should lease her real property from her real property holding company to her operating company under a written real estate lease agreement.
- She should lease, license and lend her personal property from her personal property holding company to her operating company under a written lease agreement, license agreement and promissory note.
- All of the above intercompany agreements should contain arm's-length terms.

If Jane does these things, her real estate holding company can probably charge her operating company annual real estate rentals amounting to $50,000; her personal property holding company can charge her operating company annual rents, royalties and interest totaling another $50,000; and the entire $100,000 will not only be deductible by her operating company but also exempt from BPT in the hands of her holding companies. In addition, her real estate holding company rentals will be exempt from the Self-employment Tax under Internal Revenue Code Section 1402(a)(1), and, as indicated, her personal property rental income will be exempt from FICA.

To summarize: If any of your clients own businesses with significant real estate or personal property assets (including their business names), ask yourself whether, through the adoption of holding company/operating company structures, your clients can avoid significant BPT and perhaps also significant Social Security taxes.

If the answer is yes, the accounting and legal fees to restructure your client's business may amount to a couple of thousand dollars in Year 1. However, thanks to the $50,000 Rule and the other tax rules cited above, the tax savings even in that year will probably cover these costs; and everything thereafter will be gravy. And above and beyond these tax savings, the client will gain a whole new dimension of business asset protection.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

ISSUE NO. 18 (April 18, 2005)

THE SELF-EMPLOYMENT TAX LIABILITY OF LLC MEMBERS – THE BASICS

For 2005, the Self-employment Tax (the "SET") applies at a rate of 15.3 percent on the first $90,000 of income from services and 2.9 percent of any excess. The persons who are liable for the tax are (i) as the name of the tax indicates, self-employed individuals; and (ii) individuals who are members of "multi-owner unincorporated business entities" – e.g., most general partnerships, limited partnerships and LLCs – that are taxable as partnerships under Internal Revenue Code Subchapter K.

What are the rules governing the SET liability of individuals who are LLC members? Since there are tens of thousands of such individuals in NH and millions of them nationwide, the question is an important one – and all the more so since the rate of the tax is high and since so many individuals who are LLC members hate paying it.

The Internal Revenue Code section that determines liability for the SET is Section 1402. Section 1402(a)(1) provides, in general, that self-employed individuals and "partners" owe the tax. However, various subsections of the section exclude from the tax interest, dividends, and capital gains, and Section 1402(a)(13) provides that "limited partners" don't owe the tax on their "distributive shares of partnership income."

Thus, for LLC members whose LLCs earn income other than interest, dividends and capital gains, the key SET question is: Which LLC members are "limited partners" under Section 1402(a)(13) and which are not?

The answer to this question is provided by Prop. Reg. §1.1402(a)-2 (the "Prop. Reg."), a proposed regulation that the IRS issued all the way back on January 13, 1997 but has never withdrawn or amended. For reasons I'll explain in a subsequent newsletter, even though the Prop. Reg. is technically only a *proposed* regulation, you should think of it as being, for most purposes, fully binding on both taxpayers and the IRS.

The rules of the Prop. Reg. can be summarized as follows:

1) All individuals who are members of member-managed LLCs are deemed to be "general partners" for purposes of Section 1402; these individuals owe SET on their entire share of LLC income. All individuals who are members of LLCs whose certificates of formation or similar constitutive documents (called in many states "articles of organization") or whose operating agreement indicates that these LLCs are "member-managed" are deemed to be general partners under Section 1402 and must pay SET on their entire share of LLC income. This will be so even if these individuals are completely passive investors in their LLC.

An LLC is "member-managed" if its certificate of formation or operating agreement indicates that each member has the right to sign contracts on behalf of the LLC. (The mere fact that a particular member has no interest in signing an LLC contract and, indeed, would never think of doing so is irrelevant to the issue of whether the member has contract-signing authority.)

An LLC formed under the New Hampshire LLC Act is member-managed if its certificate of formation provides that its management "is not vested in a manager or managers."

2) The four tests for limited partner status. Individuals who are members of a manager-managed LLC – i.e., an LLC whose certificate of formation and operating agreement provide that the LLC's management is centralized in one or more persons specifically appointed as managers – will be deemed to be limited partners under Section 1402(a)(13) and thus will not owe SET on their shares of LLC income if they meet each of the following four tests:

   a) They must lack personal liability for debts of their LLC.

   b) They must lack contract-signing authority for their LLC.

   c) They must not work more than 500 hours for their LLC in the relevant LLC taxable year.

   d) They must not be members of "service" LLCs. Service LLCs are those whose primary activities are in the fields of accounting, actuarial science, architecture, consulting, engineering, health and law.

3) The "single-class-of-interest rule" for avoiding SET. Under the Prop. Reg. "single-class-of-interest rule," individuals who own interests in a single class of LLC interests and who pass all of the above four tests except for the 500-hour test can avoid SET on their income in respect of that class if a "substantial portion" of the interests in the class is owned by other members who pass all four tests. Under a safe harbor provided in the Prop. Reg., the IRS will deem a substantial portion of the above interests to be owned by persons who pass all four tests if these persons own at least 20% of all interests in it.

4) The "two-classes-of-interests rule" for avoiding SET. Individuals who own interests in two or more classes of LLC interests and who flunk one or more of the above four tests will nevertheless be able to avoid SET on their income in respect of any LLC class of interest of which they own an interest if a substantial portion of the interests in that class are owned by persons who pass all four tests.

A few of the rules of the Prop. Reg. for determining the SET liability of LLC members are reasonably clear even on a first reading. However, many Prop. Reg. rules – e.g., the single-class-of-interest rule and the two-classes-of-interests rule - can't be fully understood except on the basis of detailed explanations and examples. I'll provide you with these explanations and examples in subsequent issues of this newsletter. And in the issue of the newsletter that will be published in May 2005, I'll explain why I've stated

above that even though the Prop. Reg. is merely proposed, you should treat it for most purposes as if it were final.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 19 (May 5, 2005)

IN ADVISING LLC MEMBERS ON HOW TO AVOID THE SELF-EMPLOYMENT TAX, CAN YOU RELY ON A MERE *PROPOSED* REGULATION?

EXECUTIVE SUMMARY. Prop. Reg. §1.1402(a)-2 (the "Prop. Reg.") provides IRS guidance to members of LLCs that are taxable as partnerships as to the Self-employment Tax ("SET") liability of these members. This newsletter expresses the view that the Prop. Reg. will very probably be followed by the IRS in any SET audit; that the Prop. Reg. will very probably bind the IRS in litigation; but that it probably will *not* bind LLC members themselves in litigation with the IRS regarding certain unreasonable rules that it contains.

DISCUSSION. For thousands of individuals who are members of New Hampshire multi-member LLCs taxable as partnerships and for hundreds of thousands of LLC members in other states, the question of how to reduce or eliminate their Self-employment Tax ("SET") on their shares of LLC income is of major importance. However, as indicated in last month's issue of this newsletter, the only IRS guidelines on the question are set forth in a regulation that is merely *proposed* – namely, Prop. Reg. §1.1402(a)-2. The IRS issued the Prop. Reg. on January 13, 1997 and has never withdrawn or modified it.

In advising clients who are LLC members about SET issues, every legal and tax professional must face a difficult threshold issue – namely, the issue whether you can rely on the Prop. Reg.

There are numerous cases that state or strongly suggest that you cannot. See, *e.g.*, *LeCroy Research Sys. Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984), which holds that "proposed Regulations are [merely] suggestions made [by the IRS] for comment . . . ."

As a result of cases like *LeCroy,* many tax professionals feel that in advising LLC members about their SET liability, they are on their own, with only their wits to guide them. And I can attest from personal experience that the advice given to LLC members by some of these professionals on SET matters is, to state the matter tactfully, creative, and departs significantly from the rules contained in the Prop. Reg.

I believe that tax professionals who take the view that the Prop. Reg. is unreliable and that in advising clients they may disregard it are dangerously wrong. Set forth below are (i) three important propositions about the Prop. Reg. of which I believe any tax professional can be reasonably certain; and (ii) briefly, the grounds for these propositions.

1) **UNDER *ELKINS V. COMMISSIONER*, 81 T.C. 669 (1983) (THE "*ELKINS* CASE") AND RELATED AUTHORITIES, THE PROP. REG. IS BINDING ON THE IRS WITH REGARD TO LLC MEMBERS WHO REASONABLY RELY ON IT.**

Under the *Elkins* case, the various cases that have followed it, and T.A.M. 9410004 (March 11, 1994), in which the IRS itself has implicitly acknowledged its validity, the IRS is bound even by *proposed* regulations in tax controversies with taxpayers who reasonably rely on these regulations. Furthermore, given the substantial time, effort and expertise applied by the IRS in developing the Prop. Reg., any LLC member who relies on it must be deemed to be doing so "reasonably."

2) **IN ANY AUDIT OF THE SET LIABILITY OF AN LLC MEMBER, THE IRS WILL APPLY THE PROP. REG. AND WILL NOT APPLY ANY ALTERNATIVE GUIDELINES.**

- On June 13, 2003, Lucy Clark, a national issue specialist in the IRS's Examination Specialization Program, publicly stated as follows: "If [a] taxpayer conforms to the [Prop. Reg.], we generally will not challenge what they do or don't do with regard to Self-employment Taxes." Alison Bennett, "Taxpayers Can Rely on Proposed Regulations for LLC Self-employment Tax, Clark Says," 114 BNA's Daily Tax Report (Friday, June 13, 2003) Page G-3.

  Obviously, Ms. Clark's statement is not binding on the IRS. However, it provides tax advisers with a strong basis for believing that in any audit of an LLC member's SET liability, the IRS will look to the Prop. Reg. as the sole source of its audit guidelines.

- Moreover, as indicated above, before issuing the Prop. Reg. the IRS devoted a great deal of time and effort to the issues that it addresses. We can be confident that, having done so, the IRS will not lightly set the regulation aside in any SET audit.

- Finally, even if, in auditing the SET liability of an LLC member, the IRS were tempted to depart from the Prop. Reg., a forceful reference to the *Elkins* line of authorities by the member's tax professional would very probably bring the IRS to its senses.

3) **ALTHOUGH THE PROP. REG. IS BINDING ON THE IRS, IT ARGUABLY IS *NOT* BINDING ON LLC MEMBERS WITH RESPECT TO ANY PROP. REG. RULE THESE MEMBERS CAN SHOW TO BE UNREASONABLE.**

In my view, most of the rules contained in the Prop. Reg. are reasonable but a few clearly are not. For example, I believe that the Prop. Reg. rule that members of professional LLCs (i.e., LLCs active in the fields of accountancy, actuarial science, architecture, consulting, engineering, health and law) must pay SET on the *entire amount* of their LLC income is clearly unreasonable. I say this because, among other considerations, the rule is flatly inconsistent with IRS enforcement practice with regard to the FICA liability of

individuals who are members of entities taxable as S corporations.

Moreover, I believe that a tax professional may persuasively argue that although, as indicated above, the Prop. Reg. is binding on the IRS under *Elkins*, it is *not* binding on LLC members with regard to any rules it may contain that are unreasonable. Among other considerations:

- By their terms, the *Elkins* authorities address the binding effect of IRS guidelines only as applicable to the IRS, not as applicable to taxpayers.
- Moreover, unreasonable means unreasonable. If an IRS guideline is unreasonable, it cannot stand even if it is set forth in a *final* regulation, not to speak of a regulation that is merely proposed.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 20 (June 2, 2005)

PROTECTING PASSIVE MEMBERS OF LLCs FROM THE SELF-EMPLOYMENT TAX

NINE AMBIGUITIES IN PROP. REG. §1.1402(a)-2 AND HOW TO RESOLVE THEM

EXECUTIVE SUMMARY. Prop. Reg. §1.1402(a)-2 (the "Prop. Reg.") provides in general:

- That a member of a multi-member LLC taxable as a partnership whose share of LLC income is not otherwise exempt from the Self-Employment Tax (the "SET") under Internal Revenue Code Section 1402 will be exempt from SET on that income only if he or she is a "limited partner" within the meaning of Internal Revenue Code Section 1402(a)(13); and

- That the member will be deemed to be a limited partner under that IRC section only if he or she passes each of four tests.

These four tests may be summarized as follows:

1. The personal liability test. Under the "personal liability" test, the member must not have liability for the LLC's debts solely by reason of being a member.
2. The contract authority test. Under the "contract authority" test, the member must not have authority under the governing LLC act to sign contracts that bind the LLC.
3. The 500-hour test. Under the "500-hour" test, the member must not work more than 500 hours for the LLC during the relevant LLC taxable year.
4. The service member test. Under the service member test, the member must not be a member of an LLC engaged in providing professional services in the fields of accounting, actuarial science, architecture, consulting, engineering, health or law.

Although the above four-part test is easy to apply in most cases, it also contains at least nine important ambiguities. These ambiguities and my views as to how to resolve them are discussed below. In subsequent issues of this newsletter, I will discuss the two key exceptions to the Prop. Reg. four-part test – namely, the "single-class" exception and the "two-class" exception.

DISCUSSION –NINE IMPORTANT AMBIGUITIES IN THE PROP. REG.

9) Member-managed LLCs. If, under its certificate of formation as filed with the Secretary of State, the LLC of which an individual is a member is a "member-managed" LLC – i.e., an LLC in which, under the governing LLC act, each member has the legal right to sign LLC contracts that bind the LLC – but the member is in fact entirely passive and will never sign an LLC contract, is the member nevertheless liable for SET on his or her share of LLC income?

   My answer. The answer is clearly yes. There are probably many hundreds of New Hampshire LLCs and tens of thousands of LLCs nationwide that have fallen into this SET trap. If your client's LLC is member-managed but your client is a passive LLC member and wants to avoid SET on his or her LLC income, the LLC in question must immediately amend its certificate of formation to provide that it is manager-managed. And that amendment will help your client only prospectively, not retroactively.

10) Guarantors of LLC debt. If a member of an LLC personally guarantees an LLC debt, is the member "personally liable for LLC debt" for purpose of the Prop. Reg. "personal liability" test?

   My answer. The answer is probably no. This is because such a member would be liable for entity debt not by reason of being a member under the governing LLC act, but rather, only because of the member's voluntary determination to sign a guarantee under state contractual law.

11) Bookkeepers. Is a bookkeeper an "accountant" for purposes of the "service member" test?

   My answer. The answer is probably no. This is because an individual is probably an "accountant" under that test only if he or she is licensed as a CPA or an EA and thus meets an important traditional test for being a member of a profession.

12) Veterinarians. Does a veterinarian work "in the field of health" for purposes of the service member test?

   My answer. The answer is probably yes, since, although veterinarians provide health care services only to animals, they are nevertheless clearly "professionals" in the traditional sense of the term.

13) Medical testing LLCs. Is an LLC that administers medical tests (e.g., blood pressure tests or AIDS tests for insurance companies) a "service" LLC "in the field of health" for purposes of the service member test?

   My answer. The answer is probably no, because the members of such LLCs are not normally treated under state law as professionals.

14) Proving compliance with the "500-hour test." What measures should a member take to ensure that he or she meets the "500-hour test?"

My answer. In most cases, the member will not need to keep detailed time records of his or her work for the LLC in question in order to meet this test. Instead, circumstantial evidence – e.g., evidence about the member's commitment to other work or volunteer activities – will normally suffice to meet the test.

15) Consultants. What is a "consultant" for purposes of the service member test?

My answer. The Prop. Reg. provides no answer to this question, but on this and many other questions under the Prop. Reg., reliable guidance is provided by the personal service corporation regulations under Treas. Regs. section 1.448-1T. Under those regulations, a consultant is defined very broadly as any person who provides "advice and counsel." *See* Regs. Section 1.448-1T(e)(4)(iv). (The breadth of this definition creates a dangerous SET trap for many LLCs, including, for example, LLCs whose members provide investment counseling but are not stockbrokers.)

16) Mapping and surveying services, etc. If an individual provides mapping services, surveying services and other similar services but lacks an engineering degree as such, is the individual an "engineer" for purposes of the service member test?

My answer. The answer is probably yes. *See* Treas. Regs. section 1.448-1T(e)(4)(i)(C).

17) Stockbrokers. Is a stockbroker a consultant for purposes of the service member rule?

My answer. No. *See* Treas. Regs. Section 1.448-1T(e)(iv).

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 21 (July 5, 2005)

DO NEW HAMPSHIRE MEMBERS OF SINGLE-MEMBER LLCs OWE THE I&D TAX ON DISTRIBUTIONS FROM THEIR LLCs?

EXECUTIVE SUMMARY. The DRA has indicated informally that in its view, New Hampshire members of single-member LLCs owe the Interest and Dividends Tax (the "I&D Tax") on distributions to them from their LLCs. Apparently, the DRA is not presently enforcing this position, but, needless to say, this could change at any time.

However, in my view, a careful reading of the relevant DRA regulation—namely, Rev. 901.17—makes clear that the above DRA position is flatly wrong.

DISCUSSION. For many New Hampshire residents that are members of single-member LLCs, the question in the title of this newsletter is an important one. These New Hampshire residents include, for example, individuals who conduct their businesses as single-member LLCs and who, because of Business Profits Tax reasonable compensation rules or otherwise, cannot lawfully "comp out"—i.e., cannot pay all of the net income of their LLCs to themselves in a given taxable year as compensation for their services to or for their LLCs.

> EXAMPLE: Mary Roe, a New Hampshire resident, owns and manages a single-member LLC that conducts a highly profitable construction business. Before paying Mary any compensation, the LLC has calendar year 2005 taxable net income of $1.5 million. Mary's accountant advises her that if the LLC pays compensation to her for 2005 of more than $300,000, she may face a difficult audit by the DRA.

What is the answer to the above question, and how does this answer apply to Mary Roe?

The relevant tax analysis is complex, but it can be briefly summarized in the following points:

(1) RSA 77:4,III. RSA 77:4,III provides, in effect, that the I&D Tax does not apply to New Hampshire residents that receive distributions from LLCs with nontransferable membership rights (the LLC statutory equivalent of shares).

(2) Rev. 901.17. Rev. 901.17 defines the membership rights of a New Hampshire LLC as being transferable for purposes of RSA 77:4,III only if, under the governing LLC act or the LLC's LLC agreement, these rights meet both parts of a two-part test:

(a) First, a member must be able to transfer the membership rights in question without the approval of another member (the "approval" test).

(b) Second, the transfer of these rights must not trigger the dissolution of the LLC (the "dissolution" test).

(3) Nontransferability under Rev. 901.17. It is obvious that under the above Rev. 901.17 two-part test, the membership rights of an LLC will be *non*transferable if, under the governing act or the relevant LLC agreement, the LLC in question fails *either one* of the above tests.

(4) Single-member LLCs and the "approval" test. By definition, a single-member LLC has only one member. Thus, arguably, the member of a single-member LLC will always be able to transfer the member's membership rights without the approval of "another member" and thus cannot ever fail the above Rev. 901.17 "approval" test.

(5) RSA 304-C:50. Furthermore, under the default rules of the New Hampshire Limited Liability Company Act and most other U.S. LLC acts governing LLC dissolutions, a member's transfer of the member's membership rights will not dissolve the LLC. *See*, e.g., RSA 304-C:50 (rules setting forth events triggering LLC dissolutions).

(6) Providing for transfers of membership rights as events of dissolution in the LLC agreements of single-member LLCs. However, under the New Hampshire Limited Liability Company Act and most or all other U.S. LLC acts, the member of a single-member LLC is free to enter into an LLC agreement with the LLC that will provide contractually that the member's transfer of all or any of the member's membership rights by sale or otherwise *will* trigger the LLC's dissolution. *See*, e.g., RSA 304-C:1,VI (definition of LLC agreement as applicable to single-member LLCs); RSA 304-C:50,I (contractual freedom of LLC members to determine events that will trigger their LLC's dissolution). If the LLC's LLC agreement so provides, then the membership rights issued by the LLC will be *non*transferable under the Rev. 901.17 "dissolution" test, and, as a result, under RSA 77:4,III, the LLC's member will not be liable for the I&D Tax on distributions from the LLC.

(7) LLC contractual flexibility concerning determination of dissolution events. Furthermore, the dissolution of the LLC that will occur under the LLC's LLC agreement when the member transfers the member's membership rights can be validly cancelled after that transfer by act of the member or the transferee. This is so because, among other considerations, (a) there is no provision in the New Hampshire Limited Liability Company Act nor in most other U.S. LLC acts to the contrary; and (b) the statutory hallmark of the New Hampshire Limited Liability Company Act and other U.S. LLC acts is contractual freedom—which clearly includes the right to undo the LLC's dissolution. *See* RSA 304-C:78,II (LLC contractual freedom and enforceability).

(8) Contractual freedom of LLC members to reinstate LLC as going concern after dissolution. It should be understood that in traditional partnership and LLC statutory business organization law, a dissolution is not the termination of an entity's existence; rather, it is a mere change of the entity's purpose from that of a

> going concern to that of an entity in the process of winding up. *See* RSA 304-A:30 (definition of dissolution under New Hampshire Uniform Partnership Act). However, both partnerships and LLCs are contractual entities, and under both partnership and LLC business organization law, the owner or owners of the entity (i.e., in the case of a single-member LLC, the member) are free to agree contractually to reinstate the partnership or LLC as a going concern after its dissolution. *See*., e.g., RSA 304-A:41,I. *See* Revised Uniform Partnership Act, Section 802(b) and official comments thereunder. *See* Rev. Proc. 95-10, 1995-1 C.B. 501, Section 5.01 (right of members of multi-member LLCs to vote to continue their LLCs after the dissolution of these LLCs by reason of member dissociations).

The importance of the above analysis for Mary Roe is obvious: The analysis makes clear that if her LLC distributes to her the above $1,200,000 of net profits, Mary will not have to pay the I&D Tax on this distribution. (Moreover, if Mary's single-member LLC has an S election in effect for 2005, the above $1,200,000 will not be subject to FICA.)

I am grateful to Bill Steele of William Steele & Associates, P.C., for key ideas in the above analysis. However, I alone am responsible for any error in the analysis.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 22 (August 1, 2005)

THE "TWO-CLASSES-OF-INTERESTS" RULE: PROTECTING MANAGERS OF MULTI-MEMBER LLCs FROM SELF-EMPLOYMENT TAXES

EXECUTIVE SUMMARY. Internal Revenue Service guidelines under Prop. Reg. §1.1402(a)-2 make it possible to protect individuals who are managers of multi-member LLCs taxable as partnerships from liability for the Self-Employment Tax (the "SET"). These guidelines can provide major Social Security tax savings not only for managers of both large LLCs but also for managers of very small ones.

DISCUSSION.

1) The federal income tax regimen of multi-member LLCs. Under the U.S. Treasury Department entity classification rules known as the Check-the-Box Regulations, multi-member LLCs can choose to be taxable as C corporations, as S corporations or as partnerships taxable under Internal Revenue Code Subchapter K. The default federal income tax regimen for multi-member LLCs under these rules is, of course, partnership taxation.

2) The Prop. Reg. three-test rule. The IRS guidelines determining the liability of individuals who are members of multi-member LLCs taxable as partnerships are set forth in Prop. Reg. §1.1402(a)-2 (the "Prop. Reg."). Under the Prop. Reg., individuals who are members of multi-member LLCs must, in general, pay SET on their distributive shares of LLC income unless they meet each of the following three tests:

   a) They lack personal liability for the obligations of their LLC.

   b) They work for 500 or fewer hours for the LLC during the LLC's taxable year.

   c) They lack LLC agency authority—that is, under the governing LLC act, they have no authority to sign contracts that bind the LLC.

   For a detailed discussion of these three tests, see Issue 20 of this Newsletter. To access Issue 20, click on www.llcformations.com; then click on button marked "LLC Newsletter Archives."

3) The SET problem of LLC investors who are also LLC managers. Passive investors in LLCs generally have no problem passing each of the above Prop. Reg. tests. However, many individuals who are members of multi-member LLCs are also managers of these LLCs and thus, under the governing LLC act, necessarily have LLC agency authority. In addition, many such individuals work for more than 500 hours a year for their LLCs. What if, as is often the case, these LLC manager-

members are also investors in their LLCs and are likely to derive substantial investment income from them?

EXAMPLE. Mary Roe is the manager of XYZ, LLC, a three-member LLC that has been formed to develop and sell an office building. Mary has also contributed $500,000 to XYZ, amounting to one-third of XYZ's investment capital. Mary's annual guaranteed payment for her XYZ management services is $100,000. When XYZ sells the developed office building, its net income is $3 million, all of which is ordinary income. Mary's distributive share of this $3 million is $1 million.

Because Mary is an agent of XYZ and works for XYZ for more than 500 hours in each of its taxable years, does she have to pay SET on this $1 million? In Mary's case, this SET liability would be roughly $29,000.

4) The "two-classes-of-interests" exception to the Prop. Reg. three-test rule. Fortunately for Mary, the Prop. Reg. contains an exception to the above three-test rule that will protect her from SET on her distributive share of XYZ's income. (She must, of course, pay SET on her guaranteed payment from XYZ.) The key elements of this exception—which will be referred to here as the "two-classes-of-interests rule"—are as follows:

   a) The multi-member LLC in question must have at least two classes of interests. (In drafting LLC operating agreements to comply with the two-classes-of-interests rule, I call these classes the "manager class" and the "investor class.")

   b) A substantial continuing portion of the interests in one of the above classes (the "investor class") must be held by one or more LLC members who meet all of the above three tests. The Prop. Reg. provides a safe harbor under which this "substantial continuing portion" rule will be met if at least 20% of the interests in the investor class are held by persons that meet all of the above three tests.

   c) If the above requirements are met, then individuals who hold interests in the above investor class will be exempt from SET on their distributive shares of LLC income allocated to that class even if they fail one or more of the above three Prop. Reg. tests.

5) The importance of the two-classes-of-interests rule to small LLCs. The two-classes-of-interests rule is important to individuals like Mary Roe who are both managers of and investors in highly profitable multi-member LLCs. It can also be important—indeed, in some ways, far more important—to individuals who are owners of multi-member LLCs that conduct relatively small businesses. This is because, as most readers will know, the SET applies in 2005 at a rate of 15.3% to the first $90,000 of earned income but at a rate of only 2.9% to any excess. The LLC-related earned income of many individuals who own small LLCs is well under $90,000.

EXAMPLE. John Doe and his wife Anne are equal owners of ABC, LLC, a two-member LLC that owns and operates a convenience store. ABC's annual net income averages $90,000 year before compensation to John or Anne. John is ABC's manager and works full-time for it. John thus flunks two of the above three Prop. Reg. tests. Anne keeps ABC's books but has no ABC agency

authority and works for ABC for fewer than 500 hours a year. She thus passes all three of these tests. ABC pays John an annual guaranteed payment equivalent to what it would pay a third party to perform John's responsibilities for it—namely, $35,000. ABC pays Anne a guaranteed payment of $5,000 a year. Under ABC's operating agreement, ABC has two classes of interests—namely, a manager class, of which John is the sole owner, and an investor class, of which John and Anne are equal owners. ABC allocates $500 of its annual net income to its manager class and the remainder to the investor class.

Under the above operating agreement arrangements, John's annual SET savings will, of course, vary with ABC's annual results. However, in any given year, these savings are likely to amount to several thousand dollars.

6) Subchapter S vs. Subchapter K. The managers of multi-member LLCs can also avoid Social Security taxes on their distributive shares of LLC income if their LLC elects to be taxable as an S corporation. This is because the net income of an S corporation is not subject to Social Security taxes. For multi-member LLCs, this method of avoiding Social Security taxes is often substantially simpler to implement than the method provided under the Prop. Reg. The issue of when LLCs should choose to be taxable as S corporations and when they should choose to be taxable as partnerships will be addressed in a soon-forthcoming issue of this Newsletter.

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JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 23 (September 7, 2005)

PROTECTING NEW HAMPSHIRE MEMBERS OF MULTI-MEMBER LLCs FROM THE NEW HAMPSHIRE INTEREST AND DIVIDENDS TAX

EXECUTIVE SUMMARY. In order to protect New Hampshire persons that are members of a multi-member LLC from Interest and Dividends Tax liability on distributions from their LLC, the LLC agreement of the LLC in question generally should provide as follows:

- No member of the LLC may transfer all or any part of the member's membership rights to any person except with the approval of at least one other member.
- Upon any transfer by a member of the member's membership rights, the LLC will automatically dissolve.
- However, this dissolution will be rescinded and the LLC will again become a going concern if the members either (i) vote to rescind the dissolution; or (ii) notwithstanding the dissolution, continue the LLC's ordinary business.

DISCUSSION

1) The RSA 77:4,III exception to the applicability of the Interest and Dividends Tax to New Hampshire persons. In general, the Interest and Dividends Tax applies at a rate of 5% to interest and dividends received by New Hampshire residents, including New Hampshire members of single- and multi-member LLCs. However, under RSA 77:4,III, this tax does *not* apply to distributions from LLCs with "nontransferable shares." The regulation of the New Hampshire Department of Revenue Administration that defines the RSA 77:4,III term "transferable shares"—and thus, by implication, the term "nontransferable shares"—is Rev. 901.17.

2) The application of Rev. 901.17 to multi-member LLCs. Technically, the members of LLCs do not have "shares" in their LLCs; rather, they have membership rights. I interpret Rev. 901.17 as providing, in effect, that the membership rights of an LLC are nontransferable for purposes of RSA 77:4,III if they meet either of two tests:

   a) The "approval" test. Under the first of these tests (the "approval" test), the membership rights of a multi-member LLC will be nontransferable if, under the governing LLC act or the provisions of the governing LLC agreement, no member can transfer any of the member's membership rights to a *non*-member except with the approval of at least one other member. (In my view, there are strong reasons for interpreting RSA 77:4,III and Rev. 901.17 as not requiring nontransferability as a condition for exempting New Hampshire members from

the Interest and Dividends Tax in the case of members' transfers of membership rights to other *members*.)

b) The "dissolution" test. Under the second test (the "dissolution" test), the membership rights of a multi-member LLC will be nontransferable if, under the governing LLC act or the provisions of the governing LLC agreement, a member's transfer of all or any of the member's membership rights will cause the dissolution of the LLC. (In order to understand this "dissolution" test properly, it is necessary to understand that the dissolution of an LLC does not mean the termination of its legal existence; rather, it merely means the change of its legal status from that of a going concern to that of a company required to be wound up and liquidated in an orderly manner unless the members vote to rescind its dissolution.)

3) Application of Rev. 901.17 to New Hampshire LLCs *without* written LLC agreements. In my view, the better interpretation of Rev. 901.17 is that LLCs formed under the New Hampshire Limited Liability Company Act that do not have written LLC agreements *automatically* have nontransferable shares. This is because a default rule contained in Section 46,I of that act and in certain other provisions of the act provides that unless an LLC's LLC agreement provides otherwise, none of its members may transfer any of their management rights to non-members without the approval of all other members. (For complex reasons outlined in Issue 22 of this newsletter, I believe that the Rev. 901.17 term "share" as applicable to LLCs must be interpreted to refer only to LLC *management* rights and not to LLC *economic* rights.) However, the impact of the above LLC statutory rule under Rev. 901.17 is not entirely clear.

4) Application of Rev. 901.17 to New Hampshire LLCs *with* written LLC agreements; advisability of dissolution provisions. Furthermore, for many multi-member LLCs *with* written LLC agreements that, as is very often the case, contain provisions governing members' transfers of their membership rights, the above lack of clarity can be far greater. This is because, in order to meet members' needs, these transfer provisions are often tailored in complex ways whose impact under Rev. 901.17 may be impossible to determine.

   Thus, while in LLC agreements for multi-member LLCs, the above transfer provisions should always be carefully drafted in an effort to meet the above approval test, these agreements should also generally reflect a "belt-and-suspenders" approach. That is, they generally should contain not only the transfer rules outlined in the first bullet point of the above executive summary but also the "dissolution rescission" provisions that are outlined in the second and third bullet points of that summary.

Addressing the risk in dissolution provisions. Obviously, if a dissolution rescission provision merely provides that, upon an LLC's dissolution resulting from a transfer of a membership right, the members must vote to rescind the dissolution, the members may overlook the need for a vote. If this happens, the dissolution will continue in effect, and this may invalidate the legality of LLC actions occurring after the dissolution. This is why the dissolution provisions outlined in the third bullet point in the above executive summary provide that the very continuation of a multi-member LLC's ordinary business

will be deemed to constitute a vote to rescind any dissolution resulting from a transfer of LLC membership rights.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 24 (October 6, 2005)

WHAT NEW HAMPSHIRE CPAs AND EAs SHOULD KNOW ABOUT DELAWARE LLCs

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EXECUTIVE SUMMARY. New Hampshire CPAs and EAs should advise their New Hampshire clients who are forming LLCs to seriously consider using the Delaware Limited Liability Company Act (the "Delaware Act") rather than the New Hampshire Limited Liability Company Act (the "New Hampshire Act") in the following three situations:

- High financial stakes. The financial stakes in the LLC deal in question are (or are likely to become) substantial.
- Members from two or more states. The LLC will have members from different states and if any members from one state don't want the LLC to be formed under the laws of the state of other members.
- The LLC's organizers want to obtain investment in the LLC from sophisticated investors or loans from sophisticated lenders.

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DISCUSSION

1) Similarities between the New Hampshire and Delaware Acts. The New Hampshire Act and the Delaware Act are generally similar on most legal issues important to LLC organizers, and on all of these issues, both Delaware and New Hampshire LLCs are better for most clients than corporations.

   a) Entity status. Like corporations, LLCs are entities that exist independently of their members.

   b) Liability shield. LLC members have strong liability shields that protect members' personal assets from claims against their LLCs. For smaller businesses, the LLC liability shield under both the Delaware and New Hampshire acts is stronger than the corporate shield.

   c) Management structure. The members may choose either of two management structures—namely, the member management structure and the manager management structure. For most privately held businesses, these structures are much more user-friendly than the corporate management structure.

   d) Contractual freedom. LLCs provide members with substantial contractual freedom in forming their LLCs. Corporations provide far less contractual freedom.

e) Charging order protections. LLCs provide their members with "charging order protections," which prevent creditors from obtaining ownership of member-debtors' membership rights and from forcing sales of LLC assets. Corporations don't provide these protections.

2) Legal advantages of the Delaware Act over the New Hampshire Act. From a purely legal viewpoint, the Delaware Act has the following principal advantages over the New Hampshire Act:

   a) Charging order protection advantages. The charging order provisions of the Delaware Act provide stronger and more comprehensive charging order protections than those of the New Hampshire Act. For many companies, this is the most important difference between the two acts.

   b) "Bells and whistles." The Delaware Act has various statutory "bells and whistles" that the New Hampshire Act does not have. The most important are these:

      i) Statutory conversions. The Delaware Act permits any type of entity to make a statutory conversion into any other type of entity. New Hampshire statutory conversion law is more limited.

      ii) Delegations. The Delaware Act makes it clear that members and managers of Delaware LLCs may delegate their authority to third parties. This delegation authority is arguably less clear under the New Hampshire Act.

      iii) Fiduciary duties and liabilities. The Delaware Act permits LLC members to eliminate the fiduciary duties and liabilities of those with LLC management responsibilities. For at least a few LLCs, this may be a useful capability.

   c) Case law. There is already an extensive body of LLC case law under the Delaware Act, and this body of case law is developing rapidly. There are no reported cases under the New Hampshire Act and it is likely to take many years before New Hampshire has even a few significant LLC cases.

3) The financial factor. Because of the above legal advantages of the Delaware Act over the New Hampshire Act, and particularly because of the superiority of the charging order provisions of the Delaware Act, LLC organizers and members whose LLC deals do or eventually may involve high financial stakes should generally form their LLCs as Delaware LLCs.

4) Legal disadvantages of Delaware LLCs. The main legal disadvantage for New Hampshire business people in forming LLCs under the Delaware Act is that in order to do so, they must appoint a Delaware resident agent for their LLC. This may facilitate lawsuits against the LLC in Delaware for which Delaware jurisdiction might otherwise be unavailable.

5) Costs for New Hampshire business people in forming and maintain Delaware LLCs.

   a) Delaware state LLC formation fees. The State of Delaware charges a basic fee of $90 to form an LLC. Fees for expedited formations are higher. The fee for a certified copy of the certificate of formation (which it is always a good idea to obtain) is $30.

b) Delaware state LLC maintenance fees. The State of Delaware charges an annual LLC tax of $200 to maintain the registration of Delaware LLCs, payable beginning on June 1 in the year after formation.

c) Fees charged by private companies. There are many companies located in Delaware that assist out-of-state individuals and entities to form LLCs and that serve as registered agents for them. Fees charged by these companies vary widely, but a fairly typical formation fee would be around $180 for formation services; while a fairly typical annual fee for service as a registered agent would be $160 (beginning in the year after the year of formation).

d) New Hampshire fees. The State of New Hampshire charges an annual fee of $100 to register "foreign" (i.e., non-New Hampshire) LLCs.

6) Many investors favor the Delaware Act. The Delaware Act is by far the most prestigious of all U.S. LLC acts, and it is the LLC act preferred by many sophisticated venture capital partnerships and other sophisticated private equity providers.

7) Lenders. Certain sophisticated lenders prefer (and sometimes even require) that LLCs with which they deal be formed under the Delaware Act.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 25 (November 1, 2005)

CHECKLIST FOR ACCOUNTANTS HELPING THEIR CLIENTS TO FORM LLCs

EXECUTIVE SUMMARY. There are 18 professional tasks that normally must be performed in assisting clients to form LLCs and other legal entities. These tasks are identified in the checklist below. As the checklist makes clear, nine of the tasks require a substantial knowledge of federal and state taxation of business entities and their owners. Many accountants possess this knowledge, but few lawyers do. Most of the rest of the 18 tasks require a knowledge of statutory business organization law and generally may be handled only by professionals licensed to practice law.

However, all legal and tax professionals who assist clients in forming LLCs should be familiar with the checklist and should ensure that specific tasks identified in it that are beyond their own professional expertise are handled for their clients by other professionals who possess this expertise.

THE CHECKLIST

Note. The term "tax" as used below is intended to refer simultaneously to federal income tax, Social Security Tax and state tax.

CHECK WHEN TASK IS ACCOMP-LISHED	TASKS (IN THE ORDER IN WHICH THEY SHOULD NORMALLY BE HANDLED)	AREA OF EXPERTISE REQUIRED	EXPLANATORY COMMENTS (WHERE NEEDED)
☐	1. IDENTIFY AND HANDLE ALL RELEVANT ETHICAL ISSUES.	PROFESSIONAL ETHICS	The principal relevant issues concern (i) professional competence in handling the tasks listed in this table; and (ii) (if two or more clients are involved) conflicts of interest
☐	2. OBTAIN ALL RELEVANT BACKGROUND FACTS.	BUSINESS ORGANIZATION LAW AND TAX	

CHECK WHEN TASK IS ACCOMP-LISHED	TASKS (IN THE ORDER IN WHICH THEY SHOULD NORMALLY BE HANDLED)	AREA OF EXPERTISE REQUIRED	EXPLANATORY COMMENTS (WHERE NEEDED)
☐	3. DETERMINE OPTIMAL NUMBER OF ENTITIES.	BUSINESS ORGANIZATION LAW	Many start-up businesses should be structured to include a holding company (to hold valuable business assets) and an operating company (to which the holding company will lease, license or lend these assets).
☐	4. DETERMINE OPTIMAL NUMBER OF OWNERS FOR EACH ENTITY.	BUSINESS ORGANIZATION LAW	Under the case of *In re Albright*, holding companies should have at least two owners in order to ensure charging order protections.
☐	5. DETERMINE OPTIMAL FEDERAL INCOME TAX REGIMEN FOR EACH ENTITY FOR FEDERAL INCOME TAX PURPOSES.	FEDERAL INCOME TAXATION	The choice will generally be among sole proprietorship taxation and taxation under Subchapters C, K and S.
☐	6. DETERMINE OPTIMAL FEDERAL INCOME TAX REGIMEN FOR EACH ENTITY FOR SOCIAL SECURITY TAX PURPOSES.	SOCIAL SECURITY TAXATION	Use of Subchapter S can be a powerful means to avoid Social Security Taxes. The use of Prop. Reg. § 1.1402(a)-2 may be necessary to protect from Social Security Tax individuals who are members of LLCs taxable as partnerships.
☐	7. DETERMINE OPTIMAL FEDERAL INCOME TAX REGIMEN FOR EACH ENTITY FOR STATE TAX PURPOSES.	STATE TAXATION	In most states, entities that receive pass-through taxation for federal income tax purposes will also receive state pass-through taxation .

CHECK WHEN TASK IS ACCOMP-LISHED	TASKS (IN THE ORDER IN WHICH THEY SHOULD NORMALLY BE HANDLED)	AREA OF EXPERTISE REQUIRED	EXPLANATORY COMMENTS (WHERE NEEDED)
☐	8. IF NECESSARY, RECONCILE TASKS 5-7.	FEDERAL AND STATE TAX	The federal income tax regimen that is best for federal income tax purposes may sometimes not be the best for Social Security Tax avoidance purposes or for state tax purposes.
☐	9. DETERMINE OPTIMAL STATE-LAW BUSINESS ORGANIZATION FORM FOR EACH ENTITY FOR NON-TAX PURPOSES.	BUSINESS ORGANIZATION LAW	Nontax choice of entity analyses can generally be resolved by considering three factors—limited liability; charging order protections; and management structure.
☐	10. DETERMINE OPTIMAL STATE-LAW BUSINESS ORGANIZATION FORM FOR EACH ENTITY FOR STATE TAX PURPOSES.	STATE TAXATION	In some states, some types of business entities may receive better tax treatment than others—e.g., Texas, where the Franchise Tax applies to corporations and LLCs but not to general and limited partnerships.
☐	11. IF NECESSARY, RECONCILE TASKS 9 AND 10.	BUSINESS ORGANIZATION LAW AND TAX	
☐	12. DO A CHECK-THE-BOX ANALYSIS FOR EACH ENTITY AND DO ANY NECESSARY RECONCILIATION OF TASKS 5-11	FEDERAL INCOME TAXATION	The Check-the-Box Regulations determine what type of federal income taxation is available for each type of state-law business entity.
☐	13. DETERMINE OPTIMAL BUSINESS ORGANIZATION LAW STATUTE UNDER WHICH TO FORM EACH ENTITY.	BUSINESS ORGANIZATION LAW	For high-stakes entities, Delaware business organization law statutes are often preferable.

CHECK WHEN TASK IS ACCOMP-LISHED	TASKS (IN THE ORDER IN WHICH THEY SHOULD NORMALLY BE HANDLED)	AREA OF EXPERTISE REQUIRED	EXPLANATORY COMMENTS (WHERE NEEDED)
☐	14. DETERMINE OPTIMAL MANAGEMENT STRUCTURE FOR EACH ENTITY.	BUSINESS ORGANIZATION LAW	The main types of LLC management structures are the sole proprietorship structure, the general and limited partnership structures and the corporate structure. The decision as to which management is best for a given entity can be complex.
☐	15. ASSUMING THAT ONE OR MORE ENTITIES SHOULD BE LLCs, DETERMINE THE LLC TYPE THAT BEST DESCRIBES EACH RELEVANT LLC AND, ON THAT BASIS, DETERMINE THE BEST MODEL OPERATING AGREEMENT FOR USE IN FORMING EACH LLC.	BUSINESS ORGANIZATION LAW AND FEDERAL INCOME AND SOCIAL SECURITY TAX	On the basis of the number of their members, their management structures and their tax structures, there are 14 main types of LLCs and 37 main types of model operating agreements.
☐	16. IN PLANNING, NEGOTIATING AND DRAFTING THE TERMS OF THE INTER-OWNER AGREEMENT FOR EACH ENTITY IN QUESTION, ADDRESS ALL RELEVANT BUSINESS ORGANIZATION LAW ISSUES.	BUSINESS ORGANIZATION LAW	There are five main types of LLC business organization law issues—basic factual and structural issues; financial issues; management issues; fiduciary issues; and "miscellaneous" issues (including issues relating to dissociation events, dissolutions and "boiler plate" provisions).
☐	17. IN PLANNING, NEGOTIATING AND DRAFTING THE TERMS OF THE INTER-OWNER AGREEMENT FOR EACH ENTITY IN QUESTION, ADDRESS ALL RELEVANT FEDERAL AND STATE TAX ISSUES.	FEDERAL AND STATE TAXATION	The federal income tax issues that should be addressed in owner agreements will vary greatly depending on the federal income tax regimen to which the entity in question is subject.

CHECK WHEN TASK IS ACCOMP-LISHED	TASKS (IN THE ORDER IN WHICH THEY SHOULD NORMALLY BE HANDLED)	AREA OF EXPERTISE REQUIRED	EXPLANATORY COMMENTS (WHERE NEEDED)
☐	18. IN PLANNING, NEGOTIATING AND DRAFTING THE TERMS OF THE INTER-OWNER AGREEMENT FOR EACH ENTITY IN QUESTION, ADDRESS ALL RELEVANT "MISCELLANEOUS" LEGAL ISSUES.	GENERAL BUSINESS LAW	Miscellaneous issues are issues that are neither business organization law issues nor tax issues. Examples include securities law issues and fraudulent transfer issues.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 26 (December 6, 2005)

WHAT NEW HAMPSHIRE CPAs AND EAs SHOULD KNOW ABOUT LIMITED LIABILITY

EXECUTIVE SUMMARY

Whether they know it or not, most of our clients need statutory liability shields. In theory, the liability shields provided by all of the various types of New Hampshire limited liability entities are essentially the same. However, for important practical reasons, the LLC shield is the best.

DISCUSSION

1) Types of New Hampshire business entities that confer limited liability on their owners. New Hampshire law confers statutory limited liability on the owners of four main types of business entities (referred to collectively in this newsletter as "limited liability entities"). The types of entity owners who are entitled to limited liability under New Hampshire are:
   a) The partners of limited liability partnerships ("LLPs);
   b) The limited partners of limited partnerships;
   c) The shareholders of corporations; and
   d) The members of LLCs.
2) Types of New Hampshire business entities that do not confer limited liability. Two main types of New Hampshire entities do not confer limited liability on their owners —namely, sole proprietorships and general partnerships. And under New Hampshire law, liability shields are not provided to the general partners of limited partnerships.
3) What is a liability shield? What do we mean when we say that persons who are owners of limited liability entities have statutory liability shields? We mean that if the entities owned by these persons are sued, the owners' personal assets—e.g., their homes and any stocks and other personal property they may own—will not be at risk in the suit unless, in general, these owners have been personally responsible for the actions or omissions resulting in the suit.
4) Who needs a liability shield? The theory relevant to answering this question is complex, but the answer is simple: Every business owner who has co-owners or who uses employees or independent contractors in his or her business needs a liability shield.
5) Are all New Hampshire liability shields equal? In theory, the answer to this question is yes. However, there are two main exceptions to this general statement:

a) Full vs. partial liability shields. First, while the liability shields afforded by LLCs, corporations and limited partnerships are "full" shields, the shields afforded by LLPs are only "partial" shields. In other words, LLC shields, corporate shields and limited partnership shields protect the owners of these three types of entities from claims based on negligence, contract breaches, statutory breaches and every other possible ground. By contrast, LLPs protect their owners only from claims based on negligence and other personal misconduct and not from contract claims, statutory suits or other common types of claims. This means, in general, that in New Hampshire, it is not smart to use an LLP to conduct a business.

b) The superiority of the LLC shield over the corporate shield. Second, although in theory the liability shield afforded by corporations is as strong as the LLC liability shield, in practice the LLC shield is stronger. This is because in veil-piercing claims against corporations—that is, claims that seek to hold shareholders liable for the actions of their corporations—plaintiffs' lawyers often argue that these shareholders should not benefit from their corporate liability shields because their corporation does not comply with corporate statutory formalities (e.g., the adoption of bylaws, the issuance of share certificates, and the holding of annual shareholder and director meetings). These arguments can be harmful to the many small corporations that do not have good minute books. However, the New Hampshire LLC Act *does not impose* statutory formalities on LLCs. Thus, plaintiffs' lawyers cannot use a "statutory noncompliance" argument in veil-piercing cases against LLC members.

6) Practical consequences. The above theoretical considerations lead to some very practical conclusions:

a) New businesses should be formed as LLCs. Business people who are forming new businesses and who want the strongest liability shield available under New Hampshire law should form their businesses as LLCs.

b) Existing sole proprietorships and general partnerships should convert to LLCs. Business people who conduct existing businesses as sole proprietorships or general partnerships—neither of which provides either a full or a partial liability shield—should convert their businesses to LLCs as soon as possible.

c) Existing LLPs, limited partnerships and corporations should consider converting to LLCs. Business people who conduct their businesses as LLPs, limited partnerships or corporations should seriously consider converting these businesses to LLCs. It is a matter of cost-effectiveness. Under New Hampshire law, entity conversions are generally simple, quick and relatively cheap, and they will generally have no adverse tax consequences. If a particular conversion is not unduly costly in professional fees, filing fees or internal administrative inconvenience, why not do it?

d) General partners of limited partnerships should transfer their general partnership interests to single-member LLCs. As mentioned above, under New Hampshire law the general partners of limited partnerships lack liability shields. To obtain such a shield, most or all of these general partners, whether they are individuals or

entities, should transfer their general partnership interests to single-member LLCs.

7) Limited liability vs. liability insurance. Which is more important to business people—good business liability insurance or a strong liability shield? This can be a hard question to answer. I sometimes advise certain of my clients that if they have to choose between buying liability insurance and paying me to form a limited liability entity for them, they should choose the insurance. But liability insurance policies often have loopholes in them, and sometimes the judgments that plaintiffs win against businesses exceed the business owners' liability policy limits. So for most clients, the best answer to the question is this: Get both.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 27 (December 30, 2005)

USING SINGLE-MEMBER LLCs AS OPERATING SUBSIDIARIES—TAX AND LEGAL CONSIDERATIONS

EXECUTIVE SUMMARY

No company with valuable assets should operate as a single entity; instead, in order to obtain maximum protection of these assets, its management should restructure the company into two separate legal entities—namely, a holding company and an operating company. The simplest and often the best way to achieve this holding company/operating company structure is through the use of one or more single-member LLCs.

DISCUSSION

A few New Hampshire businesses have valuable assets even when their owners first form them, and many New Hampshire businesses that begin with few or no valuable assets accumulate them over the years.

> Example. John Doe formed Doe Construction Company, Inc. ("Doe Construction") in 1990. When he launched Doe Construction's business, Doe Construction rented most of the vehicles and other equipment that it needed, and it financed the rest. However, renting and financing can be expensive; so today, Doe Construction owns outright almost all of its business assets. Taken together, these assets have a current fair market value of many hundreds of thousands of dollars and a replacement cost that is even higher.

However, if John continues to hold the above assets in the same entity as his operating company (i.e., Doe Construction) and if, because of employee negligence or otherwise, Doe Construction incurs a judgment that exceeds its liability insurance coverage, a court will almost certainly order the sale of Doe Construction's assets to cover the unsatisfied amount of the plaintiff's claim.

John can prevent the loss of Doe Construction's assets in such a situation through various arrangements. However, the arrangement that is likely to be the least expensive for John and the best arrangement for him from a tax and legal viewpoint will be for Doe Construction, Inc. to form a single-member LLC of which it will be the sole member and which will conduct all of Doe Construction's operations. This new structure will leave Doe Construction itself with only two functions—namely,

1) To lease its assets to its single-member LLC; and
2) To exercise general supervision of its single-member LLC's operations.

If, once Doe Construction has implemented its new holding company/operating company structure, its operations result in a lawsuit, only its single-member LLC will be a party to the suit; as long as Doe Construction has not participated in the wrongdoing that resulted in the suit, Doe Construction cannot be a party. The result? All of Doe Construction's assets will be protected from the suit.

Why should Doe Construction use a single-member LLC as its operating subsidiary instead of following long-standing tradition and using a wholly owned corporation for this purpose? There are two main reasons:

- First, the default federal income tax classification of entity-owned single-member LLCs under the Check-the-Box Regulations is that of "disregarded entities"—i.e., entities whose income and other tax items are deemed for federal tax purposes to be those of their parents. Thus, a corporation that is the parent of a single-member LLC need file only a single federal tax return—namely, its own return; and it need not comply with federal consolidated return regulations. By contrast, all business corporations that are C corporations but that have one or more corporate subsidiaries are required to comply with these regulations, and many such corporations find this compliance both complex and expensive.
- Second, neither multi-member LLCs nor single-member LLCs are required to comply with statutory management formalities in order to prevent third parties from "piercing their veils"—i.e., from holding their members liable for LLC negligence and other misconduct. By contrast, corporations that want to avoid veil piercing must comply with extensive management formalities.

To minimize the risk of veil piercing, what should be the management structure of single-member LLCs that are wholly owned by entity parents? Among corporate lawyers, this is a hotly debated topic. Some of these lawyers argue that since judges are likely to bring corporate concepts to veil piercing cases involving single-member LLC operating subsidiaries, not only the parents of these subsidiaries but also the subsidiaries themselves should have boards of directors and should comply religiously with all traditional board procedures.

In my view, however, this "internal subsidiary board" structure makes no sense, since, among other considerations, if the subsidiary fails in even a minor respect to comply with board formalities, this could provide plaintiffs with a strong argument in favor of piercing the subsidiary's veil and holding its parent liable for its actions.

Thus, I always recommend to clients that are setting up single-member LLC operating subsidiaries that they appoint one or more subsidiary employees as managers of these subsidiaries, although I also recommend that, to facilitate dealings with third parties, the parents give these employees traditional corporate titles such as president or chief financial officer. The resulting subsidiary management will be far more intuitive and user-friendly for the managers and employees of both the parent and subsidiary; and, in my view, it will create significantly less veil-piercing risk than a subsidiary board management structure.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 28 (February 15, 2006)

SUBCHAPTER K vs. SUBCHAPTER S—EIGHT KEY FEDERAL INCOME TAX DIFFERENCES

EXECUTIVE SUMMARY. Under the U.S. Treasury Entity Classification Regulations, the two main federal income tax options for multi-member LLCs are Subchapter K (partnership taxation) and Subchapter S. (For the vast majority of companies, the double-tax regimen of Subchapter C, which is also available under these regulations, is usually a bad choice.)

In my experience, there are eight main federal income tax issues on which differences between Subchapter K and Subchapter S can have a significant practical impact on clients. These issues and their very different treatment under, respectively, Subchapter K and Subchapter S are briefly outlined in the table below. Subsequent newsletters will discuss in greater detail each of these differences and the real-world impact of each.

SUBCHAPTER K vs. SUBCHAPTER S—TABLE OF ISSUES AND DIFFERENCES.

ISSUE	SUBCHAPTER K	SUBCHAPTER S
1) Pass-through taxation. Does entity income pass through to owners and is it taxable only to them (and not at the entity level, as under Subchapter C)?	Yes – but Subchapter K imposes no eligibility or election requirements. (Section 701)	Yes—but Subchapter S does impose potentially burdensome and risky eligibility requirements (e.g., the single class of stock requirement) and election requirements.
2) Special allocations. Can the entity allocate and distribute its profits to the members in a manner that is disproportionate to their respective contributions ("special allocations")?	Yes. (Section 704(a))	No.
3) Entity dispositions of contributed property. When an entity disposes of contributed property, can this trigger gain to the contributor? To the	Contributor may realize gain under Section 704(c)(1)(A) (the "Subchapter K pre-contribution gain" rule). Under the same section, non-contributors will not; and these non-contributors can take deductions in respect of the	Subchapter S has no equivalent of Section 704(c)(1)(A).

ISSUE	SUBCHAPTER K	SUBCHAPTER S
non-contributor?	contributed property.	
4) Treatment of post-formation contributions of property. Can post-formation contributions of appreciated property trigger a tax to the contributor?	No. (Section 721)	Yes—if the Section 351(a) "80% control rule" is violated. (See also Section 368(c) (definition of "control").)
5) Distributions of appreciated property. Are distributions of appreciated property by an entity to its owners taxable to the owners upon receipt?	Generally no. (Section 731)	Generally yes. These distributions are treated as deemed sales. Section 311(b)(1).
6) Owner redemptions. When the entity redeems the interests of an owner, can the entity (and thus the remaining owners) get a stepped-up basis in the entity's assets?	Yes, under Sections 734 and 754.	No. In Subchapter S, there is no equivalent of Sections 734 or 754.
7) Purchases of owners' interests in entities by other persons. When another person purchases the interests of an owner in an entity, can the purchaser get a stepped-up basis in the entity's assets?	Yes, under Sections 743 and 754.	No. In Subchapter S, there is no equivalent of Sections 743 or 754.
8) Inclusion of entity debt in owners' basis. When an entity incurs debt, can this debt be included in the owners' basis in their ownership interests and thus enable them to offset entity losses against their gains from other entities?	Under Section 752, 705 and other sections, yes.	No. Under Subchapter S, shareholders may include in the basis of their stock only their direct loans to their corporation. Section 1366(d)(1).

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 29 (MARCH 7, 2006)

HAVE LLCs MADE CORPORATIONS OBSOLETE FOR NEW HAMPSHIRE BUSINESS START-UPS?

EXECUTIVE SUMMARY. With the advent of LLCs, it is almost always a mistake for people starting new businesses in New Hampshire to form their businesses as corporations. Instead, both for legal reasons and for federal and New Hampshire tax reasons, these businesses should almost always be LLCs. However, this general rule has three exceptions that, for a few clients, may be important.

DISCUSSION. Thus far in 2006, New Hampshire business people have formed no less than 1,515 LLCs under RSA 304-C (New Hampshire's limited liability company statute) but only about 346 business corporations (which I'll refer to here simply as "corporations") under RSA 293-A (the state's for-profit corporation statute) —a ratio of almost five to one. As of March 7, 2006, there are roughly 32,000 New Hampshire LLCs in good standing but only about 22,000 corporations—even though the LLC form has been available in New Hampshire for less than 13 years and the corporate form for well over a hundred.

There are three main legal reasons and two main tax reason why clients should almost always form New Hampshire businesses as LLCs rather than as corporations:

1) Charging order protections. LLCs provide business owners with statutory business asset protection and other statutory protections that corporations do not provide. (Lawyers often refer collectively to these protections as "charging order protections." For a detailed discussion of charging order protections, visit www.llcformations.com and click on Newsletter No. 7 (February 1, 2004) in the newsletter archive in that website.)
2) Liability shield. From a technical viewpoint, the limited liability shield provided by LLCs and the shield provided by corporations are the same. However, the LLC liability shield is harder for plaintiffs to pierce than the corporate shield. This is because, in order to maintain their corporate liability shield, shareholders have to comply with numerous corporate statutory formalities. LLC statutes don't impose these formalities.
3) Management structure. The management structure of LLCs is far more user-friendly than the corporate management structure. Corporations have a complex quadripartite management structure consisting of shareholders, directors, officers and employees. The management structure of most LLCs is either a one-level structure called a "member management" structure or a two-level structure called a "manager management" structure. Both of these structures are simple and intuitive.

4) Federal income taxation under the Check-the-Box Regulations. Under U.S. Treasury Department entity classification rules known as the "Check-the-Box Regulations," the only federal tax regimens available to corporations are Internal Revenue Code Subchapter C and Subchapter S. By contrast, the Check-the-Box rules permit individuals who own single-member LLCs to choose among sole proprietorship taxation, Subchapter C and Subchapter S; and they permit owners of multi-member LLCs to choose among Subchapter C, Subchapter K and (with certain limitations) Subchapter S.

5) Interest and Dividends Tax avoidance. Under RSA 77:4, III, New Hampshire residents who are members of LLCs with "nontransferable shares" are not liable for the New Hampshire Interest and Dividends Tax on distributions from these LLCs. With very few exceptions, New Hampshire residents who hold shares of corporations are always liable for this tax even if these shares are nontransferable.

Is there ever a situation where a corporation will be a better choice for a New Hampshire business start-up than an LLC? I can think of only three such situations. All of them are rare.

- The business will soon go public. The first situation is when, even when the business in question is formed, it is clear that it will soon go public. Since Wall Street is willing to invest in highly promising corporations but generally not in LLCs, this business should be formed as a corporation.

  EXAMPLE. XYZ Company has breakthrough technology in a potentially very lucrative line of business and it has a management team with a superb track record. In addition, XYZ will clearly need access to public investment in order to realize its full potential. For these reasons, there is a serious possibility that XYZ will be able to make a successful public offering of its stock soon after it is formed. (For 99.999% of all start-ups, the chance that they will ever make a successful public offering—or any public offering at all—is zero.)

- The customers of the business deal only with corporations. The second situation is when, because of industry conservatism or otherwise, the customers with whom the business will be dealing are willing to do business only with corporations and not with LLCs.

  EXAMPLE. Engineers Jones and Smith are specialists in upgrading anti-pollution equipment in the smokestacks of energy utilities. They want to form a joint business to provide their services to these utilities. Some of these utilities are highly conservative and will only do business with entities that are corporations.

- The client insists. The third situation is when, even though you explain to your clients with total clarity the above five reasons why LLCs are superior to corporations for almost all New Hampshire business start-ups, the clients nevertheless insist that their business should be formed as a corporation. (Obviously, the client is king even when wrong.)

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 30 (APRIL 7, 2006)

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.

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

[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.

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.

[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.

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

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.

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 31 (MAY 1, 2006)

WHAT ARE THE LEGAL ISSUES YOUR CLIENTS SHOULD CONSIDER WHEN THEY CONVERT SINGLE-MEMBER LLCs TO MULTI-MEMBER LLCs?

EXECUTIVE SUMMARY

In the previous issue of this newsletter, I discussed the federal income tax consequences that may result under Internal Revenue Service Revenue Ruling 99-5 when a single-member LLC subject to federal income taxation as a disregarded entity is converted to a multi-member LLC taxable as a partnership. In this newsletter, I'll discuss the *legal* issues to which such a conversion may give rise. As shown below, the legal consequences of such a conversion, like the federal income tax consequences, can be major.

DISCUSSION

1) Amendment of certificate of formation not required. When the LLC converts from a single-member LLC to a multi-member LLC, its members will not have to file an amendment of its certificate of formation with the New Hampshire Secretary of State unless they want to change its management structure or other legal features provided for in its original certificate of formation. In other words, a mere change in the number of the members will not necessitate such a filing.

2) General rule—no legal changes vis a vis third parties. Furthermore, no legal relationship of the converting LLC with third parties is likely to change as a result of the conversion. For example, the LLC will continue to own all of the assets that it owned before the conversion, and there will be no change in its contract rights and duties unless the contract parties have previously agreed otherwise. Thus, unless there are specific contractual arrangements to the contrary, the conversion will have no effect on any government permit, vehicle registration, real or personal property lease agreement, loan agreement, license agreement; employment agreement or independent contractor agreement to which the LLC is a party.

3) Third-party notification issues. Furthermore, when an LLC converts from a single-member LLC to a multi-member LLC, the members generally will have no statutory or other legal duty either before or after the conversion to notify any third parties about the conversion. However, it will be wise for the members to give notice to third parties who have contractual relations with the LLC that could cause problems if these third parties find out about the conversion on their own.

   For example, if there is a significant change of ownership of an LLC, it's possible that under the relevant loan document, a bank or other lender may have the right to accelerate the pay-off of a loan or line of credit. Members should consider this possibility before converting a single-member LLC to a multi-member LLC and, if necessary, should address the acceleration issue with the lender in question before the conversion. Members and prospective members considering the conversion of a single-member LLC to a multi-member LLC should take this possibility into account before the conversion.

4) Personal guarantees. If the member of a single-member LLC was required by a third party to be guarantor of LLC liabilities—e.g., liabilities under a loan agreement or real property lease agreement—the third party may also want to impose a guarantee obligation on any additional member.

5) Workers' compensation. Under New Hampshire law, any three members of an LLC may elect to be exempt from the New Hampshire workers' compensation system. Before a single-member LLC converts to a multi-member LLC, the member and the prospective new members should consider their post-conversion workers' compensation strategy. If the conversion will result in the LLC's having *more* than three members, this consideration may be complex.

6) The need for a new LLC agreement. The conversion of a single-member LLC to a multi-member LLC will normally require the members of the converted entity to negotiate in considerable detail the legal relationship between them and to reach agreement on all relevant issues. Addressing these issues may require the assistance of a lawyer experienced in planning, negotiating and drafting LLC agreements; and the lawyer's fee for performing these tasks may be significant. However, a failure to address them may eventually be far more costly to the members, especially if, after the conversion, disputes arise between them about their LLC.

   In the next issue of this newsletter, I will discuss the main LLC agreement issues that members and prospective members should address when considering the conversion of single-member LLCs to multi-member LLCs.

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JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 32 (JUNE 12, 2006)

CONVERSIONS OF SINGLE-MEMBER LLCs TO MULTI-MEMBER LLCs—13 ISSUES YOUR CLIENTS SHOULD ADDRESS WHEN THEY NEGOTIATE THEIR LLC AGREEMENT

EXECUTIVE SUMMARY

In Issue 30 of this newsletter, I discussed the *federal income tax* consequences that may result under Internal Revenue Service Revenue Ruling 99-5 when a single-member New Hampshire LLC subject to federal income taxation as a disregarded entity is converted to a multi-member New Hampshire LLC taxable as a partnership. In Issue 31, I discussed the important *legal* consequences to which such a conversion may give rise.

However, in these previous newsletter issues, I did not address the legal and tax questions that will arise when the original LLC member and his or her new co-member negotiate the LLC agreement between them. In this newsletter, I will address these questions. First, however, it will be useful to address the question whether the original and new members will need an LLC agreement at all.

DISCUSSION

The need for a sound, written LLC agreement. In the case of a multi-member LLC, an LLC agreement is, in effect, the partnership agreement among the members; it defines the nature of the LLC's business and the rights and duties of the members. In any multi-member LLC that involves significant financial or personal stakes, there are three main reasons why the members should negotiate and sign a comprehensive LLC agreement:

- The need to change statutory default rules that don't work for the LLC in question. First, there are several "default rules" in the New Hampshire Limited Liability Company Act that, for many multi-member LLCs, simply do not work. For example, the New Hampshire LLC Act provides, in effect, that the LLC will make no distributions of cash to the members unless the LLC agreement specifically requires them. However, most LLC members want the LLC to distribute to them, at the very least, enough cash to enable them to pay any federal and state taxes they may owe on their shares of LLC income on time and in full.

- The need to address "statutory gaps" in the New Hampshire LLC Act. Second, there are many important multi-member LLC legal issues that the New Hampshire LLC Act simply does not address or addresses inadequately —for example, issues concerning members' duties of care and loyalty, and, in particular, their duty not to compete against the LLC.
- LLC agreements as teaching documents and users' manuals. Third, even apart from purely legal considerations, well-drafted LLC agreements can be invaluable teaching documents for persons considering becoming members of an LLC and users' manuals after the LLC is formed.

However, under the New Hampshire LLC Act, a merely verbal agreement among the members of an LLC will be invalid; the Act requires that LLC agreements be in writing. (By contrast, oral "operating agreements"—the term for LLC agreements under the Massachusetts LLC Act—are valid; but if there are member disputes, these written agreements are likely to be worthless, since it is normally very hard to prove to a judge or jury the contents of oral agreements.)

It is possible to find good forms for LLC agreements on the Internet. However, to my knowledge, there are no such forms that are tailored for use under the New Hampshire LLC Act, much less for the unique needs of specific LLCs and their members. Thus, if the members of a multi-member LLC decide they need such an agreement, they should seriously consider hiring (i) a competent LLC lawyer to help them negotiate and draft it; and (ii) a good tax professional (whether he or she is a CPA, an enrolled agent or a tax lawyer) to advise them on how to resolve the federal and state tax issues that they and their LLC will inevitably confront. If the same professional can help them with both their legal and their tax issues, so much the better.

LLC agreement issues. What should be the contents of an LLC agreement under the New Hampshire LLC Act? In my view, every good LLC agreement for a multi-member LLC under the New Hampshire LLC Act should do the following:

1) Alteration of statutory default rules that don't work for the deal in question. As I've mentioned, the LLC agreement should alter all of the default rules of the New Hampshire LLC Act that do not fit the LLC deal in question.
2) Filling of "statutory gaps." As I've indicated, the LLC agreement should address all of the legal and tax issues between the members that aren't addressed by the New Hampshire LLC Act.
3) "Introductory" issues. The LLC agreement should contain provisions concerning the name of the LLC, the identities of its members, its principal place of business, its taxable year, its method of accounting, and other basic "introductory" issues.
4) Basic financial provisions. The LLC agreement should address all basic issues among the members concerning their contributions to the LLCs, their rights to allocations of LLC income and losses, their rights to distributions of LLC cash and other assets, their capital accounts, and their compensation for services to or for the LLC.

5) Events of dissociation. The LLC agreement should identify the "events of dissociation"—i.e., events, such as death, disability, resignation, bankruptcy, expulsion and perhaps divorce, that the members agree should cause members to cease being members.

6) Buy-sell provisions. The LLC agreement should contain comprehensive buy-sell provisions that specify when the LLC can issue ownership interests to existing and new members; when the members can sell their memberships to other persons; and what rules, including price and non-price provisions, should govern LLC buy-outs of deceased and other dissociated members.

7) Member meetings, voting and information rights. The LLC agreement should contain reasonably comprehensive rules concerning member meetings and members' voting and information rights.

8) Manager titles, etc. The LLC agreement should contain rules concerning managers' titles, appointments, removals and functional responsibilities.

9) Fiduciary duties. As I've indicated above, the LLC agreement should contain clear rules concerning the duty of care, duty of loyalty, duty of confidentiality and other important ethical and fiduciary duties that the members will have toward one another.

10) Claims by members and managers. The LLC agreement should contain rules governing claims by members and managers against one another. These rules should generally provide that claims may be brought only in arbitration and not in court.

11) Federal income tax rules. If the members and their tax advisers agree that the LLC should be taxable as a partnership, the LLC agreement should contain all of the tax provisions required by Subchapter K for the LLC in question. If the LLC will be an S corporation for federal income tax purposes, the LLC agreement should contain the very different federal income tax rules that are necessary under Subchapter S.

12) New Hampshire tax provisions. The LLC agreement should contain provisions that will protect the LLC's members to the extent possible from Social Security Taxes and the New Hampshire Interest and Dividends Tax and that will protect the LLC itself from the New Hampshire Business Profits Tax. (The Interest and Dividends Tax can be avoided by appropriate provisions in the LLC agreement restricting transfers of membership rights and providing for dissolution upon these transfers. The BPT can be avoided by appropriate compensation provisions, by a "Qualified Investment Company" election if appropriate and by various other means.)

13) "Miscellaneous" provisions. The LLC agreement should contain provisions about various significant "miscellaneous" questions, such as LLC books and records, outside tax and legal advisers, dissolution, and questions about amendments, governing law, waivers and other "boilerplate" issues.

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

ISSUE NO. 33 (JULY 8, 2006)

A BIRD'S-EYE VIEW OF THE LLC WORLD--THE 16 LLC TYPES

EXECUTIVE SUMMARY

LLCs provide legal and tax advantages that no other business organization form can provide. As a result, there are presently about 4 million U.S. LLCs, including about 32,000 LLCs formed under the New Hampshire Limited Liability Company Act and, remarkably, about 360,000 under the Delaware Limited Liability Company Act. These LLCs come in 16 basic types. In understanding the LLC form and in assisting in LLC formations, it is indispensable for both accountants and lawyers to have at least a general familiarity with each of these types and with their various subtypes.

DISCUSSION

1) Introduction; the three factors relevant in categorizing LLCs. All LLCs share certain common features—for example, the fact that they may be operated informally and that they provide liability shields to their members. As a result of these common features, the 4 million U.S. LLCs in the aggregate may appear to non-specialists to form a kind of vast amorphous blur.

   However, all LLCs can be categorized and assigned to specific LLC types and subtypes on the basis of three relatively simple factors—namely, (i) the number and type of their members; (ii) their management structure; and (iii) their tax structure. On the basis of these three factors, it is possible to identify 16 basic types of LLCs and a total of 41 subtypes. It can be highly beneficial both to accountants and to lawyers to obtain at least a basic understanding of each of these factors. For example, this understanding is indispensable to lawyers in choosing the right model operating agreements for LLCs they are helping clients to form; and it is indispensable to accountants in advising their clients about whether their LLCs have the right management and tax structure. I will briefly address each of these three factors below.

   Readers who wish to have comprehensive tables covering the 16 main types of LLCs and the principal subtypes can download these tables by visiting my website at www.llcformations.com and clicking first on the home page button marked "LLC Library" and then on the link entitled "Overview of LLC Types" (the "LLC Overview").

2) Number and type of members. LLCs can have either a single member or multiple members. Single-member LLCs, in turn, can be separately categorized on the basis of whether their members are individuals or entities. This distinction between individually owned and entity-owned LLCs is important because, among other considerations, the provisions of model operating agreements for the two types of LLCs differ greatly.

3) The management structures available to single-member LLCs. As shown in the LLC Overview mentioned above, single-member LLCs owned by individuals can be either member-managed or manager-managed, and manager-managed single-member LLCs owned by individuals can be managed either by the members themselves (called "member-managers" in LLC legal terminology) or by third parties (called "non-member managers"). Single-member LLCs owned by entities can be managed either by a single individual (who can use either the title "manager" or a corporate title such as "president"); by two or more individuals; or by an internal board of directors.

4) The management structures available to multi-member LLCs. Whether they are owned by individuals, by entities or by a combination of individuals and entities, multi-member LLCs can have any of three basic management structures—namely, a traditional general partnership structure; a traditional limited partnership structure; or a corporate management structure. However, each of these three structures can be set up either as a simple or as a complex structure.

   For example, an LLC that has only a few members and that engages in a group professional practice should generally have a simple general partnership management structure under which each member may participate directly and fully in LLC management and in which there are no management formalities.

   By contrast, an LLC that conducts a group professional practice but has many members will generally need a complex management structure that involves committees, annual and special meetings of the members, quorum rules and other specialized governance arrangements needed by larger entities.

5) Tax structures available to single-member LLCs. Under the U.S. "Entity Classification" regulations (often referred to by tax professionals and others as the "Check-the-Box Regulations"), single-member LLCs owned by individuals can be subject to federal income taxation as "disregarded entities" (the default federal tax classification), S corporations or C corporations. Most such LLCs should be either disregarded entities or S corporations; only a very few should be C corporations.

6) Tax structures available to multi-member LLCs. Under the Check-the-Box Regulations, multi-member LLCs may be taxable as partnerships (the default federal tax classification), C corporations or S corporations. Most such LLCs should be either partnerships or S corporations for federal tax purposes; only a very few should be C corporations. However, it is sometimes useful for LLCs that have corporate management structures to be taxable under Subchapter C. Thus, lawyers should have model operating agreements for this type of LLC as well as for the other types of LLCs mentioned above.

7) Two-member LLCs vs. LLCs with three or more members. On the basis of the number of their members, LLC professionals generally think of LLCs as either single-member LLCs or multi-member LLCs. However, from a management viewpoint and for purposes of drafting LLC operating agreements, there are many significant differences between multi-member LLCs with only two members and those with three or more members. Among other things, the issue of management deadlock is ever-present for two-member LLCs but normally far less significant for LLCs with three or more members. This distinction figures significantly in the charts in the above LLC Overview.

8) LLCs that are taxable as partnerships tailored to avoid Social Security Taxes and those that are not. In general, individuals who are members of LLCs taxable as partnerships must pay Social Security Taxes on their shares of LLC income unless this income is passive—i.e., income in the form of capital gains, dividends, interest, or real estate rentals. However, a proposed IRS regulation known as Prop. Reg. § 1.1402(a)-2 provides guidelines that enable these individuals to achieve at least a partial avoidance of Social Security Taxes on LLC active income. Thus, in understanding the category of LLCs taxable as partnerships, it is necessary to make a distinction between those that are structured to avoid Social Security Taxes under the Prop. Reg. and those that are not. This distinction, too, is reflected in the LLC Overview mentioned above.

9) Series LLCs. In recent years a new type of LLC—namely, the "series" LLC—has emerged. The provisions in LLC statutes that authorize the formation of these LLCs provide, among other things, that the members of a series LLC may hold various classes of assets and various lines of business in various separate "series" and that each such series will be insulated from claims against any other series. Series LLCs thus enable LLC members to avoid the costs and complexities of holding assets and lines of business that they would incur if they held their assets and conducted their various lines of business through multiple LLCs. Instead, each LLC series can be made to function for these members and their LLC like a wholly owned single-member LLC subsidiary. Series LLCs also offer many interesting (but as yet wholly uncharted) possibilities for federal tax avoidance.

   However, only five states thus far (namely, Arizona, Delaware, Indiana, Iowa and Oklahoma) have provided for series LLCs in their LLC statutes, and it is doubtful that the above liability protections will be respected by the courts of other states. Thus, the LLC Overview mentioned above makes reference to series LLCs as a separate type of LLC, but this overview calls for only a single basic model operating agreement for them.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

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WHEN A MULTI-MEMBER LLC BECOMES A SINGLE-MEMBER LLC— TAX AND LEGAL RULES YOUR CLIENTS SHOULD KNOW

EXECUTIVE SUMMARY

Because of a member's death or otherwise, multi-member LLCs often change to single-member LLCs. When this change occurs, dangerous legal and tax consequences can easily result. The present issue of this newsletter addresses the principal legal consequences of such a change. In so doing, it focuses primarily on changes of two-member LLCs to single-member LLCs, and it assumes that these two-member LLCs have only individuals as members. However, the legal points below will often apply equally to multi-member LLCs with three or more members, including one or more members that are entities.

A forthcoming issue of the newsletter will consider the tax consequences of such a change.

DISCUSSION

1) Preparing for the change. As soon as the members of a multi-member LLC know that their LLC will soon change to a single-member LLC, they should consider consulting with an accountant and a lawyer with LLC expertise as to the tax and legal issues that will arise from the change. Both the legal and the tax issues can come as surprises; and many of them may arise from local law or from facts unique to the LLC in question. As illustrated below, handling these issues may be impossible except on the basis of advance preparation.
2) "Events of dissociation," etc. Under the New Hampshire Limited Liability Company Act and every other state LLC act, a potentially wide variety of events—called "events of dissociation"—can cause LLC members to cease being members and thus to cause a two-member LLC to change to a single-member LLC. The principal such events are (i) the death of a member who is an individual; (ii) the dissolution of a member who is an entity; (iii) the disability of an individual member; (iv) member resignation; (v) member bankruptcy; (vi) member buy-out (whether by cross-purchase or by redemption by the LLC); (vii) a member's expulsion; and (viii) under many LLC agreements, a member's divorce.

The statutory legal consequences of events of dissociation vary widely from event to event and from one LLC act to another, and these consequences can often be heavily affected by any LLC agreement that may apply among the members. As indicated above, LLCs and their members should prepare in advance for these consequences. Preparing in a competent manner usually requires a carefully negotiated written agreement among the members.

3) New LLC agreement. By definition, a single-member LLC owned by an individual is subject to complete control by that individual. Thus, it may seem counterintuitive that such an LLC needs a written LLC agreement. However, the need is clear and urgent. Among other considerations:

   a) The New Hampshire Limited Liability Company Act contains numerous default statutory rules that simply don't work for many single-member LLCs—e.g., the rule that if an LLC member becomes personally bankrupt, he or she is no longer a member. Under the New Hampshire Act, this and other unworkable statutory rules not only need to be changed; they can only be changed in a legally binding manner through a *written* LLC agreement.

   b) A written LLC agreement can be an invaluable means for providing the members of single-member LLCs with a clear understanding of the legal and tax structure of their LLCs and its proper administration. If the LLC is taxable as an S corporation (which is by far the best federal tax regimen for many New Hampshire single-member LLCs), the guidance of a written LLC agreement can be particularly important.

4) What should be the contents of LLC agreements for single-member LLCs?

   a) Statement of background. It will often be useful to begin the LLC agreement of a LLC that has changed from a multi-member LLC to a single-member LLC with a statement of background (often referred to by lawyers as "recitals") that gives a brief history of the LLC and, in particular, specifically notes this change. This statement can provide an indispensable context in addressing LLC issues that arise after the change.

   b) Basic LLC information. The LLC agreement should provide basic information about the LLC's name, management structure, method of accounting, taxable year and tax structure.

   c) Alteration of default rules. The LLC agreement should alter the above "dissociation upon bankruptcy" rule and all other default rules in the governing LLC act that are unsuitable for single-member LLCs owned by individuals.

   d) Assistant manager. In most cases, the LLC agreement should appoint the member as the manager of the LLC, but it should also appoint as an assistant manager a person trusted by the member; and it should provide that if, because of the death or disability of the member or the occurrence of other specifically identified circumstances, the assistant manager may validly act as the manager. This will ensure continuity of LLC management if something happens to the member.

e) Contributions. The LLC should state the amount of any contribution made by the member to the LLC; and if the member owes no contribution (as will usually be the case when a multi-member LLC changes to a single-member LLC), it should so state.

f) Subchapter S issues. As noted, if the LLC was originally an S corporation or elects to be taxable as an S corporation, the LLC agreement should provide various guidelines for ensuring the preservation of the LLC's S election.

5) LLC certificates of formation. The certificate of formation of many multi-member LLCs provides that these LLCs are "member-managed"—i.e., that any member can sign contracts for the LLC and otherwise participate in its management. When a multi-member LLC changes to a single-member LLC, it may be necessary to amend the LLC's certificate in various ways, but particularly to provide that it is *manager*-managed, since, without this change, the single-member LLC's assistant manager may well lack the legal authority to act for the LLC.

6) Contracts and insurance policies, etc. In general, the fact that an LLC changes from a multi-member LLC to a single-member LLC should not affect the validity of any contracts to which it is a party, including, for example, insurance contracts, real and personal property lease agreements, line-of-credit agreements and mortgage agreements. However, loan agreements and mortgage agreements often have provisions that call for acceleration of repayment upon a change of ownership; and many debt agreements and real estate and personal property lease agreements to which LLCs are parties include provisions for personal guarantees by members. Thus, before a multi-member LLC changes to a single-member LLC, the members should review all of their loan agreements and other contracts to ensure that the change will have no adverse contractual consequences.

7) Post-dissociation competition. When a member of a multi-member LLC is dissociated from the LLC, this can sometimes create a risk that eventually, if not immediately, the dissociated member will compete with the LLC, use its customer list, seek to hire away its employees, or interfere in some manner with its suppliers or other key third parties with whom the LLC does business. The best way to prevent these various consequences is through a written agreement between the departing member and the remaining members that is signed by the parties *before* the departing member is dissociated.

8) Veil-piercing. Single-member LLCs are often more vulnerable than multi-member LLCs to veil-piercing claims in state and federal courts—i.e., to claims by third parties that the members' personal assets should be at risk in claims against the LLC. Thus, when a multi-member LLC changes to a single-member LLC, its member should carefully consider whether he or she is taking all necessary measures to prevent such claims. The February 1, 2004 issue of this newsletter (archived on my website) provides several anti-veil piercing guidelines that these individuals may wish to consider.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 35 (SEPTEMBER 17, 2006)

NOW THAT LLCS ARE AVAILABLE, SHOULD NEW HAMPSHIRE BUSINESS PEOPLE EVER USE LIMITED PARTNERSHIPS?

EXECUTIVE SUMMARY

The enactment of the New Hampshire Limited Liability Company Act has made limited partnerships all but obsolete in New Hampshire. However, there are a few practical, legal and tax reasons why at least a small number of New Hampshire business people may find limited partnerships preferable to LLCs.

DISCUSSION

1) Limited partnerships—introduction. A limited partnership is a partnership that has at least one general partner and one limited partner. To form one, you have to file a "certificate of limited partnership" with the New Hampshire Secretary of State. In general, only the general partner of a limited partnership may sign contracts for the limited partnership and deal on its behalf with third parties. Every general partner of a limited partnership has unlimited personal liability for limited partnership debt.

   New Hampshire law has provided for limited partnerships since 1916, and its current limited partnership act was enacted in 1988. By contrast, the New Hampshire Limited Liability Company Act (the "LLC Act") was not enacted until 1993, and LLCs only became widely useful for New Hampshire businesses in 1997, when the Check-the-Box Regulations became effective and the LLC Act was amended to take advantage of those regulations.

2) Principal similarities between limited partnerships and LLCs. There are many significant similarities between limited partnerships and LLCs under New Hampshire law and from a federal tax viewpoint. For example, both limited partnerships and LLCs provide "charging order protections"— powerful statutory asset protections that corporations do not provide. And the default federal income tax classification of both limited partnerships and LLCs under the Check-the-Box Regulations is that of partnerships taxable under Internal Revenue Code Subchapter K.

3) Principal difference between limited partnership and LLCs. However, LLCs have so many important legal advantages over limited partnerships that, for almost all New Hampshire business people, the limited partnership form has become obsolete. For example:

a) Liability shield. All of the members of an LLC have a strong liability shield. Only the limited partners of a limited partnership have a liability shield, and these limited partners can easily lose the protections provided by this shield if they misstep—for example, by participating too much in the conduct of the limited partnership's business.

b) Single member vs. multiple members. As noted, limited partnerships must have at least two partners—namely, at least one general partner and at least one limited partner. LLCs need have only a single member. This means, among other things, that if either a general partner or a limited partner in a two-partner limited partnership ceases being a partner—e.g., because of death—the limited partnership will automatically be dissolved and must be wound up unless it quickly obtains a replacement partner. By contrast, if a two-member LLC loses a member, this will have no effect whatsoever on the LLC's continuity of life.

c) The limited partnership/general partnership link. Limited partnership law is a combination of general partnership statutory law and limited partnership statutory law, and sometimes it can be difficult to determine which statute governs—the general partnership statute or the limited partnership statute. This potential source of statutory confusion does not exist for LLCs.

4) Does it ever make sense to use a limited partnership instead of an LLC for a New Hampshire business start-up? Given the above strong legal advantages of LLCs over limited partnerships, are there any situations in which it may still make sense for New Hampshire business people to use limited partnerships in start-up businesses? I can think of only the following situations:

a) Limited partnerships as investment vehicles. Limited partnerships have traditionally been used as investment vehicles, and many investors are more comfortable with limited partnerships than with LLCs for this purpose. Thus, from a purely marketing viewpoint, it may sometimes make more sense to use a limited partnership than an LLC in an investment venture.

b) The "statutory passivity" of limited partners. The default statutory rules of the Limited Partnership Act are generally more pro-manager than the default rules of the LLC Act. Business promoters who want their investors to have as little power in their investment entities as possible may thus prefer the limited partnership form to the LLC form. (However, failure to disclose the relative lack of management power of limited partners can, in some situations, give rise to significant federal or state securities law hazards.)

c) State and Canadian tax considerations. The tax laws of a few states and, apparently, Canada, may in some circumstances be more favorable to limited partnerships than to LLCs.

d) Estate planning discounts. A few estate planning professionals believe that limited partnerships can provide better discounts than LLCs (though many other estate planning professional disagree with this belief).

e) Charging order protections—the *Catamount Construction* case. There is a New Hampshire Supreme Court case (called "*BayBank v. Catamount Construction*")

that provides strong judicial support for the validity of limited partnership charging order protections. There is no such New Hampshire case with regard to LLC charging order protections. (However, because the charging order provisions of the Limited Partnership Act and the LLC Act are essentially identical, I have little doubt that a New Hampshire court would view the *Catamount Construction* case as conclusive in interpreting the LLC Act.)

f) Self-Employment Tax considerations. Internal Revenue Code Section 1402(a)(13) can be read as providing that all limited partnership income allocated to a limited partner is automatically exempt from Self-Employment Taxation. One could argue that the complicated IRS rules under Prop. Reg. § 1.1402(a)-2 (the "Prop. Reg.") that determine the Self-Employment Tax liability of LLC members don't apply to limited partners; and I somewhat doubt that the IRS would seek to apply the Prop. Reg. to limited partners. (However, I believe if a limited partner does not meet the Prop. Reg. SET tests, he or she faces at least a modest SET audit risk. Why run that risk if you don't have to?)

5) Should existing New Hampshire limited partnerships convert to LLCs? There are presently at least a couple of thousand active New Hampshire limited partnerships. In light of the above discussion, should some or all of them convert to LLCs? (Under New Hampshire law, such a conversion is relatively easy and inexpensive to accomplish.) Here are my thoughts in regard to this question:

a) Protecting the general partner. If the general partner of a New Hampshire limited partnership is an individual, he or she will automatically obtain a strong liability shield if the limited partnership converts to an LLC. However, it will normally be much easier and cheaper to provide the general partner with this shield if the general partner simply forms a single-member LLC and contributes his or her general partnership interest to it.

b) The greater administrative simplicity of LLCs. On the other hand, it is cumbersome to manage a limited partnership through a single-member LLC general partner, and this can create liability risks. Thus, assuming that the legal and tax professionals who assist a limited partnership are willing to accomplish the limited partnership's conversion to an LLC for professional fees that are reasonably affordable, the fact that LLCs are easier to administer than limited partnerships may justify a limited partnership's conversion costs.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 36 (OCTOBER 16, 2006)

VALUING OWNERSHIP INTERESTS IN CLOSELY HELD NEW HAMPSHIRE CORPORATIONS AND LLCs[5]

EXECUTIVE SUMMARY

There is no generally reliable method for valuing the stock of New Hampshire closely held corporations or of membership rights in New Hampshire LLCs. However, for both tax and legal purposes, the starting point in valuing these interests should normally be an old but still highly authoritative Internal Revenue Service revenue ruling designated Rev. Rul. 59-60, 1959-1 C.B. 237. In addition, in appraising any business, there are also a small number of New Hampshire Supreme Court cases that New Hampshire business appraisers must take into account.

DISCUSSION

III. INTRODUCTION TO REV. RUL. 59-60; GENERAL CONSIDERATIONS UNDER THE RULING

New Hampshire CPAs, EAs and lawyers are often asked by their clients to assist them in determining the value of their businesses and thus of ownership interests in these businesses. These requests can arise in the context of gift or estate tax issues, in connection with buy-outs of deceased or retired business owners by remaining owners, in connection with sales of businesses to third parties, and in various other contexts. For all of these purposes, these professionals must take into account the key federal tax authorities and New Hampshire legal authorities.

The principal federal authority is Rev. Rul. 59-60. Although the IRS issued this ruling in order to provide guidance in valuing business ownership interests for gift and estate tax purposes, the ruling also provides valuable guidance for all other business valuation purposes.

Rev. Rul. 59-60 is eight pages long, and every sentence in it requires careful consideration. However, for purposes of valuing New Hampshire closely held

[5] I am grateful for the many useful ideas and authorities that I have obtained from the lawyers of McLane, Graf, Raulerson & Middleton, Professional Association, to which I am of counsel, in my writing of this newsletter. However, the views in this letter are not necessarily those of any other McLane lawyer, and I alone am responsible for an errors in the letter.

companies, the ruling can be viewed as reflecting six general principles and 17 specific valuation factors. The six general principles are set forth below. The 17 specific valuation factors are addressed in Part II of this newsletter. The relevant New Hampshire case law is briefly addressed in Part III.

1. <u>Meaning of fair market value</u>. The fair market value of corporation stock and LLC membership rights (which I'll refer to jointly as "business ownership interests") means the price at which the interests would change hands between a willing buyer and a willing seller when (a) the former is not under any compulsion to buy; (b) the latter is not under any compulsion to sell; and (c) both parties have reasonable knowledge of the relevant facts. Regs. § 20-2031-1(b).
2. <u>Importance of objective data</u>. Any appraisal of business ownership interests should be based to the fullest possible extent on properly compiled financial statements and other objective data.
3. <u>No generally applicable formula</u>. Because the relevant facts vary so much from one business to another, there can be no generally applicable formula for valuing business ownership interests. Instead, the appraiser, in appraising the value of these interests, must ascertain and duly consider each of these facts and must apply not only informed judgment but also common sense and reasonableness.
4. <u>Risks</u>. Any valuation of a business must give due weight to the risks that are likely to confront the business presently and in the reasonably foreseeable future. These must include both risks to the business as such, risks relevant to the industry in which the business operates, and general economic risks.
5. <u>Capitalizations of earnings</u>. Many valuations of businesses are likely to involve a capitalization of reasonably foreseeable business net income. Just is there is no generally applicable formula for valuing businesses themselves, so too, there is no generally applicable formula for capitalizations of earnings.
6. <u>Unavoidable difficulty and uncertainty</u>. Because any such appraisal will require a prediction about future profits, the task will inevitably be difficult and the results uncertain and subject to varying opinions.

IV. VALUATION FACTORS UNDER REV. RUL. 59-60

However, Rev. Rul. 59-60 identifies 17 specific factors (some of which are explicit in the ruling and others clearly implicit) that it defines as potentially important in defining the valuation of particular businesses and thus of ownership interests in these business. These factors are as follows:

Factor 1. <u>Nature of the business</u>. What is the nature of the business? For example, what various products and services does it provide to its customers?

Factor 2. <u>General economic conditions</u>. Which facts (if any) concerning the local or national economic situation are relevant in valuing the business?

Factor 3. <u>Economic outlook in relevant industry</u>. What is the economic outlook in the specific industry in which the business is involved?

Factor 4. Book value of business ownership interests. What is the book value of the business's business ownership interests?

Factor 5. History of business. What has the history of the business been since its formation? For example, over the years, have its lines of business changed significantly; and what have been the relevant trends in its profitability?

Factor 6. Financial condition of the business. What is the current financial condition of the business?

Factor 7. Earning capacity of the business. What is the earning capacity of the business?

Factor 8. Dividend-paying capacity of the business. What capacity does the business have to pay dividends?

Factor 9. Goodwill. Does the business itself have goodwill or other intangible value, or is the goodwill of the business more properly attributable to its individual owners?

Factor 10. Previous sales of interests in the business. Has the business previously sold any of its business ownership interests to any person? If so, what were the terms of each such sale?

Factor 11. Sales of interests in similar businesses. Have there been any sales of business ownership interests of similar businesses? If so, what have been the terms of these sales?

Factor 12. Competition. How strong are the current and possible future competitors of the business?

Factor 13. Effect of loss of managers, etc. Will the loss of any of the business's managers or employees—for example, the death of the business owner triggering the buy-out in question—be likely to adversely affect the value of the business? If so, to what extent will "key man" insurance or other factors be likely to offset this effect?

Factor 14. Classes of business ownership interests in the business. Does the business have more than one class of business ownership interests? If so, how do the legal characteristics of these various classes affect their value?

Factor 15. Control vs. minority. Do the specific business ownership interests that are the subject of the relevant buy-out provide for control of the company, or do they constitute a mere minority interest in it? In either case, what premium or discount should be applied to the interests in question?

Factor 16. Inter-owner agreements. Is there any agreement among the owners of the company that restricts the sale of business ownership interests in the company or that otherwise affects the value of these interests?

Factor 17. Relationship of parties to inter-owner agreements. Assuming that such an agreement exists, does the relationship among its parties—e.g., as, on the one hand, independent unrelated persons or, on the other, as members of

the same family—affect its objectivity and thus its utility in valuing interests in the business?

In any valuation of a closely held business and of ownership interests in that business, one must begin by giving reasonable consideration to each of the above 17 factors. However, my experience is that in most such valuations:

- Many of these factors will prove to be irrelevant.
- Factors that are not addressed in Rev. Rul. 59-60 either expressly or even implicitly but that can be identified by diligent research and reflection concerning the business in question will often decide all significant valuation issues relating to the business.

Excellent comprehensive guidelines on the valuation of corporate stock may be found in Mezullo, 831-3rd T.M., Valuation of Corporate Stock.

V. KEY NEW HAMPSHIRE CASE LAW RELEVANT TO BUSINESS VALUATIONS

Important recent New Hampshire cases relevant to business valuations include *In the Matter of Watterworth & Watterworth*, 149 N.H. 442 (2003) and *Rattee v. Rattee*, 146, N.H. 44 (2001). It is important for appraisers of New Hampshire companies to be generally familiar with these cases, but in my view, both of them—and all other relevant New Hampshire cases—not only are entirely consistent with the Rev. Rul. 59-60 but also add nothing significant to the guidelines contained in that ruling.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 37 (NOVEMBER 19, 2006)

MORE BASIC PROBLEMS WITH LIMITED PARTNERSHIPS—GENERAL PARTNER CONTRIBUTIONS AND CAPITALIZATION[6]

EXECUTIVE SUMMARY

There are at least four potentially significant tax and legal issues concerning the amount of capital the general partner of a limited partnership must possess and the amount the general partner must contribute to the partnership on which there is no clear case law or other authority. In certain circumstances, any of these issues may constitute a substantial reason for avoiding the use of the limited partnership business organization form.

DISCUSSION

1) Introduction

In Issue No. 35 of this newsletter, dated September 18, 2006, I pointed out various similarities and differences between LLCs and limited partnerships under federal income tax law and New Hampshire business organization law, and I identified the very few situations in which a limited partnership may be preferable to an LLC for New Hampshire business people.

In addition to the legal and tax problems with the limited partnership form I mentioned in Newsletter Issue No. 35, readers should be aware of four additional problems that can arise specifically with respect to the general partners of limited partnerships. For some New Hampshire businesses, these problems, each of which I will briefly discuss below, may cause the limited partnership form to be even more unattractive.

2) The general partner "insufficient contribution and "insufficient interest" problems under federal income tax law

There is no clear federal tax authority on the issue of how much a general partner must contribute to a limited partnership and how much of an interest in the partnership the general partner must have in order to qualify as a general partner for federal income tax purposes. Thus, while it is likely that even a relatively small contribution and general partner interest will suffice for these purposes, we cannot be certain of this proposition, especially if the general partner in question makes only a small contribution to a limited

[6] I am indebted to Craig Standish, an associate with the law firm of McLane, Graf, Raulerson & Middleton, Professional Association, for the legal and tax research underlying this newsletter. I alone, however, am responsible for any error in the newsletter.

partnership that has a very substantial capitalization. *See generally, Davison, Eleanor* (1953), 12 CCH TCM 293; *Rankowski, Frank* (1956), 14 CCH TCM 1441; see generally, Rands, *Passthrough Entities and Their Unprincipled Differences in Federal Tax Law*, 49 SMU Law Rev. 15 (1995).

However, if, in any such case, the Internal Revenue Service is successful in contending that the general partner's contribution or interest is insufficient, the federal income tax results for the partnership and for many of its partners may be serious. They may include, for example, a radical reallocation of partnership debt among the partners, which may result both in partner loss of basis and in partner recognition of phantom gain.

By contrast, under all U.S. LLC statutes, a person can serve as the manager of an LLC without making any contribution to it whatsoever. Thus, LLCs are entirely immune to the above general partner "insufficient contribution" and "insufficient interest" federal income tax issues.

3) The "insufficient contribution" issue under LLC business organization law

There is also no clear authority on how much the general partner of a limited partnership must contribute to the partnership in order to be viewed as a bona fide general partner for purposes of determining the legal validity of the partnership. In every case where a general partner makes only a small contribution to the partnership, this may open the door to a troubling claim against the partnership by a plaintiff that contends that an entity that purports to be a limited partnership is actually a general partnership, in which, accordingly, every partner has unlimited personal liability for entity debt. *See generally*, *Pearl v. Shore*, 95 Cal. Rptr, 157 (Cal. Ct. App. 1971); *Fisser v. International Bank*, 282 F.2d 231 (2d Cir 1960); *Arnold v. Browne*, 27 Cal. App. 3d 386 (Cal. Ct. App. 1972).

4) The "insufficient general partner capitalization" issue under LLC business organization law

Finally, there is no clear authority on how much capital the general partner of a limited partnership must have in order to meet the "adequate capitalization" requirement for overcoming veil-piercing claims. In the case of such a claim against a general partner who is an individual, the failure of the individual to have adequate capital may cause all of the assets of the individual and of the limited partners to be at risk in a claim against the purported limited partnership. In the case of such a claim against a general partner that is an entity, the assets both of the limited partners and of the individuals or entities that own the entity that is the general partner may be at risk. *See* cases cited in above paragraph.

It is true that in a veil-piercing case against an LLC, the LLC *itself* may have to show that its *own* capitalization is adequate for veil-piercing purposes. However, no *member* of the LLC need make such a showing. Thus, for LLCs, the adequacy of the personal assets of the manager is entirely irrelevant in a veil-piercing claim and cannot provide the basis for such a claim.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 38 (DECEMBER 15, 2006)

WHAT WILL HAPPEN TO AN LLC WHEN ONE OF ITS MEMBERS BECOMES BANKRUPT?

EXECUTIVE SUMMARY

When an individual who is a member of a multi-member LLC incurs a court judgment that the member cannot pay, LLC statutory "charging order protections" will provide the insolvent member, the LLC and the other members with substantial protection from creditors. However, if, because of the judgment, the insolvent member becomes bankrupt, the trustee in bankruptcy will be able to take over all of the bankrupt member's LLC membership rights and thus, if the bankrupt member controls the LLC, to force the liquidation of the LLC. But the other members can avoid this result if they are able to prove that the insolvent member, because of his or her business acumen or otherwise, offers unique advantages to the LLC that the trustee in bankruptcy cannot offer.

DISCUSSION

1) Charging order protections

Among the most powerful statutory provisions of the New Hampshire Limited Liability Company Act are the "charging order provisions" of Section 47. Section 47 provides, in effect, that when a creditor of an LLC member obtains a court judgment against the member, the only remedy available to the creditor with regard to the member's LLC membership is a "charging order." A charging order is a court order against an LLC requiring that any distributions of LLC profits that would normally go to an insolvent member of the LLC must go instead to the creditor. Section 47 prevents creditors from taking possession of any "management" rights of the insolvent member, including the member's voting rights. Virtually all other U.S. LLC acts contain similar provisions. Thus, under Section 47, if a creditor obtains a judgment against a member who has voting control of an LLC, this will not enable the creditor to force the sale of the LLC's assets and their distribution to the creditor in satisfaction of the judgment.

No corporate statute provides charging order protections. The availability of charging order protections under LLC statutes provides LLCs with one of their most important legal advantages over corporations.

2) Impact of member bankruptcy on LLC

However, it often happens that individuals who are members of an LLC and who incur judgments that they cannot pay decide that, in order to escape the burden of their debts, they must declare personal bankruptcy. In the event of such a bankruptcy, what will

happen to an LLC member's LLC membership rights, and what will happen to the LLC itself?

The first thing that LLC accountants and lawyers must understand about this situation is that, when an LLC member becomes bankrupt, Section 47 and the various protections it provides from creditors will not be available to the bankrupt member, the other members or the LLC as a source of protection from any trustee in bankruptcy that a court may appoint in the member's bankruptcy case to ensure payment of the member's creditors. This is because trustees in bankruptcy are not creditors of the member. Rather, under the federal bankruptcy act, they step into the shoes of the member and effectively become the owner of all of the member's property. This includes the member's LLC voting rights, agency rights, information rights and all other LLC membership rights the member may have under the governing LLC act and LLC operating agreement.

Thus, in general, if an individual who becomes bankrupt has majority voting rights in an LLC, the trustee in bankruptcy will take over those rights; and the trustee, unlike any mere creditor of the member, can vote to require the LLC to sell all of its assets and divide up the proceeds among the member's creditors and the non-bankrupt members.

3) <u>Section 365(b)(1)(C)</u>

However, there is a potential catch for the trustee in bankruptcy, and this catch can sometimes greatly benefit the bankrupt LLC member and the LLC itself. The catch arises under Section 365(b)(1)(C) of the federal bankruptcy act. As applicable to LLCs, this section provides, in effect, that if, after an LLC member has become bankrupt, the trustee in bankruptcy seeks to become a substitute member in place of the bankrupt member, the LLC can prevent this result if it can prove to the bankruptcy court that because of the bankrupt member's know-how or for other reasons, the bankrupt member provides significant value to the LLC that the trustee in bankruptcy cannot provide.

This showing will often be easy to make in the case of a majority member who manages an LLC; and in the case of a member whose only role is to vote on significant LLC matters, the very possibility that the LLC and the other member *might* be able to make such a showing may force the trustee in bankruptcy to cut a deal with the bankrupt member that will be far more favorable to the member and to the LLC than if the member were merely passive.

The lesson of Section 365(b)(1)(C) for accountants and lawyers who want to ensure that LLC members and their LLCs will have maximum legal protection if any member becomes bankrupt is to ensure that the relevant LLC agreement provides that each of the members, including non-manager members, has significant access to LLC information and a significant vote on all important LLC matters and thus, at the very least, is a continuing source of sound business judgment for the LLC.

Thus, for example, under the LLC agreement of an LLC that is managed by the wife but in which the husband is also a member, the husband should normally have the same voting power as the wife, and, ideally, the two members should actually vote on all significant LLC matters and should briefly record the fact and the outcome of their votes.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 39 (JANUARY 22, 2007)

WHAT ACCOUNTANTS (AND LAWYERS, TOO) SHOULD KNOW ABOUT THE MANAGEMENT STRUCTURES OF SINGLE-MEMBER LLCs OWNED BY INDIVIDUALS

EXECUTIVE SUMMARY

Both for legal and for tax reasons, the management provisions in an LLC agreement will normally be among the agreement's most important provisions. These provisions should be structured very differently depending on whether an LLC is owned by one individual; by one entity; or by two or more entities or individuals. Accountants should have at least a general understanding of how LLC management provisions should be structured. Lawyers who form LLCs should have a very detailed understanding of these provisions.

This newsletter addresses the legal and tax issues that arise in choosing management structures for single-member LLCs owned by individuals. Subsequent newsletters will address these issues as applicable to:

- Single-member LLCs owned by entities; and
- Multi-member LLCs.

DISCUSSION

LEGAL CONSIDERATIONS IN DESIGNING THE MANAGEMENT STRUCTURE OF A SINGLE-MEMBER LLC OWNED BY AN INDIVIDUAL

The management structure of an LLC means the set of rules in the governing LLC act and in the relevant LLC operating agreement that determines:

- Who may sign contracts on behalf of an LLC;
- Who may decide LLC issues (such as who shall be the managers of the LLC; whether and when the LLC will make distributions; and whether the LLC will be dissolved); and
- Who may conduct the LLC's day-to-day business.

Although accountants who are not lawyers are barred by ethical rules from drafting the management provisions and the other provisions in LLC agreements, they should have at least a general understanding of these provisions, so that if clients ask them to review LLC agreements for them from a financial or tax viewpoint, they can also warn their

clients if, in the course of their review, they see obvious errors in the LLC's management structure. As indicated, lawyers who draft LLC agreements need to have a very detailed understanding of LLC management structures.

Most or all U.S. LLC acts provide for two distinct LLC *statutory* management structures —the "member-managed" structure and the "manager-managed" structure. Under the former structure, any person who is a member of an LLC may perform any and all LLC management functions. Under the latter, these functions may be performed only by persons (whether members or non-members) who are specifically appointed as members in the LLC's LLC agreement. Under most U.S. LLC acts, including the New Hampshire act, whether an LLC is member-managed or manager-managed is determined by its articles of organization (called a certificate of formation under the New Hampshire LLC Act).

However, in the *real* world of LLCs (as opposed to the *statutory* one), there is far more to an LLC's management structure than indicated by any LLC act. In the real world, single-member LLCs owned by individuals can any of three quite different management structures.

1) <u>Member-managed single-member LLC</u>. If the certificate of formation of a single-member LLC owned by an individual provides that it is *member*-managed, then, by statute, the individual who is the LLC's member will also automatically be its manager.
2) <u>Manager-managed single-member LLC with member as manager and with one or more assistant managers</u>. If the certificate of formation of such an LLC provides that the LLC is *manager*-managed, then, in the LLC's LLC agreement, the member will normally appoint himself or herself as the LLC's manager but may also appoint one or more other persons who are not members to serve as assistant managers. (In LLC jargon, these assistant managers are called "non-member" managers.)
3) <u>Manager-managed single-member LLC with non-member managers</u>. If the certificate of formation of such an LLC provides that the LLC is manager-managed, then, in the LLC agreement, the member may also appoint a *non*-member as the LLC's manager (and may also appoint one or more *other* non-members as assistant managers if the business needs more than one manager).

However, there is a strong statutory argument that if the certificate of formation of a single-member LLC owned by an individual provides that the LLC is member-managed, then the *only* person who may lawfully manage the LLC is the member. If this legal argument is valid, then if, because of illness, absence or otherwise, the member of a member-managed single-member LLC owned by an individual is unable to manage the LLC, then the LLC's management will grind to a halt and *no one* will be able to substitute for the member in depositing checks for it, paying bills for it or performing any other management functions for it.

Thus, to provide for continuity of management in the event that something happens to the member, the certificate of formation of a single-member LLC owned by an individual should almost always provide that the LLC is manager-managed, and the LLC's LLC

agreement should almost always appoint the member as the LLC's manager and one or two non-members as assistant managers. In the case of many small single-member LLCs owned by individuals, the best assistant manager will often be the member's spouse.

However, if the individual who owns a single-member LLC wants to avoid the hassles and the potential legal liabilities of a manager, then, in the LLC's LLC agreement, this individual should appoint one or more *third parties* as the LLC's managers.

- In the case of an LLC that operates a convenience store, the manager might be an individual whom the member knows to be a competent and trustworthy store manager.
- In the case of an LLC that owns and operates an apartment building, the manager might be a property management company. However, there should be a well-drafted property management agreement between the LLC and this company, which should provide, among other things, that the manager is fully insured and will have exclusive liability for any claim against the LLC.

FEDERAL TAX CONSIDERATIONS IN DESIGNING THE MANAGEMENT STRUCTURE OF A SINGLE-MEMBER LLC OWNED BY AN INDIVIDUAL

The following are the main tax considerations that accountants should be aware of in reviewing the management structure of a single-member LLC owned by an individual:

1) Accountants should be aware that whether the LLC is member-managed or manager-managed, the member will owe full-freight Social Security Tax on the LLC's income if the LLC is taxable as a sole proprietorship (which will be the federal income tax structure of a single-member LLC owned by an individual if the LLC doesn't file an S election).
2) Whether the LLC is member-managed or manager-managed, the member will owe Social Security Tax only on the net income of the LLC if the LLC does file an S election.
3) However, if the LLC is manager-managed and files an S election and if, under its LLC agreement, the member is not appointed as a manager, this will assist the member in arguing that he or she is not active in the LLC's business and thus ought not to be liable for Social Security Tax on its net income.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 40 (FEBRUARY 21, 2007)

WHAT ACCOUNTANTS AND LAWYERS SHOULD KNOW ABOUT ENTITY-OWNED SINGLE-MEMBER LLCs

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EXECUTIVE SUMMARY

For corporations and other entities, including LLCs, that can benefit from holding assets or conducting operations through wholly-owned subsidiaries, the best entity choice for these subsidiaries is often a single-member LLC. However, in forming a single-member LLC to serve as a subsidiary, a parent entity should give careful consideration to all relevant legal and tax issues, including, especially, issues concerning the subsidiary's management structure.

DISCUSSION

INTRODUCTION; LEGAL ADVANTAGES OF SINGLE-MEMBER LLCs AS SUBSIDIARIES

It is often wise for corporations and other entities to hold valuable business assets and to conduct business operations through one or more wholly-owned subsidiary entities.

> EXAMPLE. XYZ, Inc. manufactures widgets. Its manufacturing equipment is worth $1 million. To protect this equipment, XYZ should hold it directly but should conduct its manufacturing, sales and service operations in a wholly-owned subsidiary. This holding company/operating company structure is likely to provide powerful business asset protection to XYZ's equipment if the subsidiary's operations ever result in a lawsuit. Assuming proper structuring, any resulting judgment will very likely be against the subsidiary, not against XYZ itself.

In deciding what type of entity it should use as a subsidiary, a parent company has two main choices—a state-law business corporation of which it will be the sole shareholder or a single-member LLC of which it will be the sole member. Its choice should almost always be a single-member LLC. From a business organization law viewpoint, single-member LLCs are substantially better than corporations. Among other considerations:

1) The liability shield provided by single-member LLCs to their members is at least as strong as that provided by corporations to their shareholders.
2) Entities that own single-shareholder corporations must comply with numerous burdensome statutory formalities, and their failure to comply with them can create a risk of veil-piercing. LLCs are subject to only the most minor formalities.

FEDERAL AND STATE TAX CONSIDERATIONS

The federal and state taxation applicable to single-member LLCs is also generally better than that applicable to single-shareholder corporations. Briefly:

1) Single-member LLCs as "disregarded entities." Except as otherwise provided under Internal Revenue Code Subchapter S, corporate subsidiaries will be subject to taxation as C corporations, and, in general, their parents must determine their tax liabilities in accordance with U.S. Treasury consolidated return regulations. These regulations are complex and can sometimes yield unwanted results. By contrast, by reason of federal Entity Classification Regulations (the famous "Check-the-Box Regulations"), almost all single-member LLCs owned by entities are classified as "disregarded entities" for federal tax purposes. This means that their tax items are treated as those of their parents, and their parents need not be concerned about the consolidated return regulations.
2) State taxation. Under the tax laws of most states, single-member LLCs are treated as pass-through entities whose taxation is generally similar to that of disregarded entities under federal rules. Furthermore, while single-member LLCs are subject to entity-level taxes under the New Hampshire Business Profits Tax and Business Enterprise Tax, careful tax planning can generally assure that the aggregate New Hampshire tax liability of entities that use single-member LLCs as subsidiaries will be the same as if these entities operated without subsidiaries.

DO SINGLE-MEMBER LLCs OWNED BY ENTITIES NEED LLC AGREEMENTS?—MANAGEMENT STRUCTURE ISSUES

Entities that form single-member LLCs as subsidiaries should enter into LLC agreements with their subsidiaries that will alter the default rules of the governing LLC act to the extent that these rules are inappropriate for single-member LLCs and that will properly determine the tax and legal structure of these LLCs. The key issue that should be addressed in the LLC agreement of such an LLC should be its management structure. In general:

1) The manager of the single-member LLC owned by an entity should never be the parent entity itself, since this will increase the risk that the parent will be sued for activities of the subsidiary.
2) If the business activities of the single-member LLC subsidiary are relatively limited, the subsidiary should be managed by an individual appointed as manager by the board of directors, managers or other governing persons (the "Governing Body") of the parent.
3) If the business activities of the subsidiary are somewhat complex, the subsidiary should be managed by two or more managers appointed by the parent's Governing Body. The titles and functions of these single-member LLC managers will generally resemble those of corporate officers.

4) If the business activities of a subsidiary single-member LLC are extensive, the parent should consider appointing an internal board in the subsidiary to exercise general supervision of the subsidiary's activities. However, board operations are inevitably complex and potentially expensive, and any failure of the internal board of a single-member LLC subsidiary to comply with traditional corporate statutory formalities applicable to boards may create a risk of veil-piercing for the subsidiary's parent. Thus, in general, appointing internal boards for single-member LLC subsidiaries is not a good idea.

INTERCOMPANY AGREEMENTS BETWEEN PARENTS AND SINGLE-MEMBER LLC SUBSIDIARIES

For both tax and legal reasons, parents should always establish carefully constructed intercompany agreements between themselves and their subsidiaries, whether these subsidiaries are single-member LLCs or single-shareholder corporations. These agreements may be, among other things, supply agreements, real property and personal property lease agreements, license agreements, loan and security agreements, and agreements under which the parent provides administrative services to the subsidiary. The terms in these agreements should always be arm's-length terms. For both tax and legal purposes, a good basis for drafting these terms is the set of intercompany rules set forth in the U.S. Treasury Regulations under Internal Revenue Code Section 482.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 41 (MARCH 8, 2007)

DRAFTING FEDERAL TAX PROVISIONS FOR THE LLC AGREEMENTS OF LLCs TAXABLE AS S CORPORATIONS

EXECUTIVE SUMMARY

For smaller companies both in New Hampshire and in other states, the best possible structure is to be an LLC for law purposes and an S corporation for federal tax purposes. The LLC agreement of such an LLC should contain, in addition to the usual purely legal provisions, special federal tax provisions addressing key Subchapter S issues. These Subchapter S provisions should include, above all, a provision requiring the LLC to select as its tax adviser a CPA or EA who is expert in Subchapter S and to consult with this adviser regularly.

DISCUSSION

For almost all businesses in New Hampshire and in most other states, the strong liability shield of the LLC form and its legal and tax flexibility and informality make it by far the best business organization form. However, most smaller New Hampshire LLCs—i.e., those that provide compensation to their members of less than the Social Security Tax base—$97,500 for 2007—should make an S election in order to minimize their Social Security Tax burden (assuming that they and their tax advisers assume that to avoid this tax is in their best long-term interest). If they make this election, they will incur the New Hampshire Business Profits Tax on their net income (at a rate of 8.5%, but the tax will be deductible federally), but they will save Social Security Taxes at a rate of 15.3%. In states that treat S corporations as pass-through entities for state tax purposes, the net tax saving can be much greater.

However, if an LLC is an S corporation for federal tax purposes, should its LLC agreement (called an operating agreement in Massachusetts and most other states) contain any special Subchapter S tax provisions?

8) In my view, the operating agreement should *not* contain summaries of any of the Subchapter S entity-level and shareholder-level rules governing eligibility for S corporation eligibility nor any other Subchapter S substantive rules as such. Most members won't understand or remember these rules and will only be annoyed by them.

9) Rather, the purpose of the Subchapter S provisions in the agreement should be to set forth rules and structures that teach the members about the importance of properly making an S election and maintaining it until the day (which, however, will probably never come) when the members decide to voluntarily revoke it.

10) In particular, the agreement should provide as follows:

    a) The agreement should provide that before or promptly after the formation of the LLC and the signing of the agreement, the members must find a CPA or EA who is an expert in Subchapter S and must appoint this individual as the LLC's tax adviser, and it should contain a general provision requiring the members to consult with this tax adviser about all significant plans and activities of the LLC to ensure that they will not create risks under that subchapter.

    b) In addition, the agreement should contain a section that specifically identifies all of the various types of transactions that can terminate or significantly jeopardize the LLC's S election and that specifically requires the members to consult with the LLC's tax adviser before effecting any of these transactions. The section should provide more or less as follows:

        i) Allocations and Distributions. The members shall consult with the LLC's tax adviser before the LLC makes any allocation or distribution not previously approved by the LLC's tax adviser.

        ii) Member Compensation, Etc. The members shall consult with the LLC's tax adviser before the LLC makes any change in its compensation to the members for their services to or for the LLC.

        iii) Issuance of Shares, Etc. The members shall consult with the LLC's tax adviser before the LLC issues (a) any shares or other LLC membership rights to any member or to any other person; or (b) any warrant or option for any such shares or other membership rights.

        iv) Sale of Shares, Etc. The members shall consult with the LLC's tax adviser before any member sells, gives or otherwise transfers or disposes of all or any part of the member's shares or other membership rights to another member or to any other person.

        v) Redemptions. The members shall consult with the LLC's tax adviser before the LLC redeems all or any part of any member's shares or other membership rights.

        vi) Loans. The members shall consult with the LLC's tax adviser before any member makes any loan to the LLC and before the LLC makes any loan to a member.

        vii) Withholding of Taxes, Etc. The members shall consult with the LLC's tax adviser before the LLC withholds or pays taxes on behalf of the members to any federal, state or other tax authority in a manner not already approved by the tax adviser.

viii) Change in Estate Plan. Each member shall consult with the LLC's tax adviser before the member makes any change in his or her will or in any trusts or other estate planning documents or arrangements of the member.

ix) Acquiring Ownership Interests in Another Entity. The members shall consult with the LLC's tax adviser before the LLC acquires an ownership interest in any other entity.

x) Change of LLC's Purpose, Etc. The members shall consult with the LLC's tax adviser before making any change in the LLC's purpose or lines of business.

xi) Change of Accounting Method or Taxable Year. The members shall consult with the LLC's tax adviser before changing the LLC's accounting method or taxable year.

xii) Death of a Member. Upon the death of a member, the other members shall use reasonable best efforts to consult with the LLC's tax adviser about possible Subchapter S issues that may arise because of the death.

xiii) Other Actions. The members shall consult with the LLC's tax adviser before any member or the LLC takes any other action relating to the LLC or its business or internal affairs outside the ordinary course of the LLC's business.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 42 (APRIL 2, 2007)

WHAT ACCOUNTANTS AND LAWYERS SHOULD KNOW ABOUT THE MANAGEMENT STRUCTURES OF MULTI-MEMBER LLCs

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EXECUTIVE SUMMARY

Multi-member LLCs (i.e., those with two or more members) can have any of three basic management structures—a general partnership structure, a limited partnership structure or a corporate structure. Choosing the right management structure for a multi-member LLC can be important not only for legal and business reasons but also for purposes of avoiding Social Security Taxes.

DISCUSSION

Accountants don't normally assist their clients in planning and drafting voting provisions, contract authority provisions and other management provisions for multi-member LLCs of which the clients plan to become members. However, all accountants should have at least a general understanding of these structures. This is because, among other considerations, LLC management structures can have important tax consequences (as discussed below). And obviously, lawyers who assist clients in forming LLCs must have a deep understanding of these structures.

Set forth below are the basics of what accountants and lawyers should know about the management structures of multi-member LLCs. My LLC formbook and practice manual, *DRAFTING LIMITED LIABILITY COMPANY OPERATING AGREEMENTS*, published by Aspen Law & Business, contains tailored forms for multi-member LLCs with all of the various types of management structures described below.

1) Member-managed vs. manager-managed multi-member LLCs. On the basis of their management structures, LLC lawyers generally divide multi-member LLCs into two basic kinds —namely, *member*-managed LLCs and *manager*-managed LLCs. In multi-member LLCs that are *member*-managed, every member has statutory authority to bind his LLC in oral and written contracts. In a multi-member LLC that is *manager*-managed, only those persons (whether they are members or non-members) who are expressly named as managers in the LLC's operating agreement may bind the LLC in contracts. Under the New Hampshire Limited Liability Company Act, the issue whether an LLC is member-managed or manager-managed is decided by its certificate of formation, which must state whether the management of the LLC is or is not vested in a manager or managers.

2) Member-managed multi-member LLCs and Social Security Taxes. Most multi-member LLCs are subject to federal income tax treatment as partnerships (although, in my view, most of them should in fact be taxable as S corporations). A fact of which even some of the most sophisticated accountants are unaware is that if a multi-member LLC that is taxable as a partnership is member-managed under its certificate of formation, then, under an IRS regulation called Prop. Reg. § 1.1402(a)-2 (the "Prop. Reg."), all of its members who are individuals will automatically be subject to the Self-Employment Tax on their shares of LLC income. And this will be so even if these individuals are completely inactive in the LLC and would never think of signing a contract for it. The reason is that under the Prop. Reg., individuals who have *statutory authority* to sign LLC contracts are subject to the Self-Employment Tax, whether or not they ever *actually* sign them; and all members of member-managed multi-member LLCs automatically have statutory contract-signing authority.

3) Use of Subchapter S by multi-member LLCs to avoid Social Security Taxes while still member-managed. What does this mean for an LLC in which all the members want the right to sign contracts and to fully participate in LLC management, but also want to minimize their Social Security Tax burdens? The answer is simple: This LLC must make an S election. If the LLC is taxable as an S corporation, then the Prop. Reg. won't apply to it and all of the net income of the LLC will automatically be exempt from Social Security Taxes.

4) The need to go beyond the "member-managed/manager-managed" distinction. Knowledge of the above distinction between member-managed and manager-managed LLCs is indispensable in order to protect LLC members from Social Security Taxes. However, the distinction is a dangerous oversimplification for LLC organizers, members and others in determining the precise management structure that their LLC should have for legal and other non-tax purposes, including management efficiency and effectiveness. This is because, as indicated above, there are, as a practical matter, three quite different basic management structures available to multi-member LLCs, and there are significant management subsets within each of these three categories.

   To explain briefly:

   a) The simple general partnership management structure. In LLCs which have relatively few members but in which all of the members want roughly equal management rights and authority, the management structure should be that of a classic simple general partnership—i.e., a structure in which all members, like partners in a general partnership, can vote on all LLC matters, can sign LLC contracts and can participate directly in the conduct of the LLC's business.

   b) The complex general partnership management structure. However, if all of the members of an LLC want equal management rights but the LLC has relatively numerous members—say, more than eight—then the LLC should have a "complex" general partnership management structure—i.e., one in which, for the sake of management efficiency, the members agree that many specified management matters, potentially including very significant ones like the

admission of new members, are reserved to a managing director or a management committee.

c) "Manager-controlled" and "member-controlled" simple limited partnership management structures. If one or more members of an LLC do not want the burdens and potential liabilities of being LLC managers or if one or more members don't want one or more *other* members to be managers, then the LLC should have a simple limited partnership management structure—i.e., a structure that has few management formalities but in which day-to-day business matters are reserved to one or more managers whose functions generally resemble those of the general partners of limited partnerships. .

   However, any multi-member LLC that has a simple limited partnership management structure can be structured under its operating agreement as either a *manager-controlled* or a *member-controlled* LLC. In the former type of LLC, the manager has the right to decide not only day-to-day LLC business matters but also important "extraordinary" matters such as whether the LLC shall be dissolved. In the latter, all important LLC matters and even specified matters relating to the LLC's day-to-day business are reserved to the members. A number of LLC cases suggest that LLCs with the latter structure will be more effective in protecting LLC business assets than the former.

d) Complex limited partnership management structures. In addition, member-controlled LLCs in which the members want clearly specified rights to monitor the managers and to participate in LLC decision-making need to have *complex* limited partnership management structures with detailed provisions concerning member and manager meetings, information rights and voting rights.

e) Corporate management structures. Finally, it sometimes happens that the members of an LLC do not want to directly monitor the LLC's managers or to participate directly in the decision of significant LLC matters but do want representatives to perform either or both of these functions for them. These LLCs need a *corporate* management structure, in which the managers of the LLC will be the equivalent of corporate officers and the above representatives of the members will be the equivalent of corporate directors.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 43 (MAY 17, 2007)

WHICH LLC ACT IS BETTER FOR YOUR CLIENTS—THE NEW HAMPSHIRE ACT OR THE MASSACHUSETTS ACT?

EXECUTIVE SUMMARY

The financial provisions of the Massachusetts Limited Liability Company Act (the "Massachusetts Act") and numerous other provisions in that act are essentially the same as those in the New Hampshire Limited Liability Company Act (the "New Hampshire Act"). However, on many important LLC issues, there are significant differences between the two statutes. For some clients, these differences may be critical in choosing the act that will govern their LLC deal.

DISCUSSION

Many New Hampshire accountants and lawyers—and especially those practicing in the southern tier of New Hampshire—have clients both in New Hampshire and in Massachusetts. These accountants and lawyers sometimes assist clients in LLC deals in which some of the parties reside in New Hampshire and others in Massachusetts. In these situations, clients may ask their lawyers or accountants which LLC act—the New Hampshire Act or the Massachusetts Act—is likely to be better for the various individual parties or for the deal overall.

The answer to this question will depend to a substantial degree on the individual situations of the clients in question; and in many such situations, the best resolution of the question will be to form the LLC under the Delaware LLC Act—often referred to as "everybody's second choice" in choosing among LLC acts.

However, for New Hampshire and Massachusetts clients who don't want the extra expense and complexities of using the Delaware Act, I'll describe below the chief general points of comparison between the New Hampshire and Massachusetts acts.

1) Filing fee. The filing fee to create an LLC under the New Hampshire Act is $100. The corresponding Massachusetts fee is $500. However, if you form an LLC under the New Hampshire Act but plan that it will engage in significant business activities not only in New Hampshire but also in Massachusetts, you will have to register the LLC in Massachusetts—and the Massachusetts registration fee is also $500.

2) Online formation of LLC. You can create an LLC online under the Massachusetts Act. In order to create a New Hampshire LLC, you must file a certificate of formation in person or by mail; there is no online filing.

3) The seven chief LLC statutory characteristics. Under most U.S. LLC acts, LLCs have seven chief statutory characteristics. As illustrated in the following table, the New Hampshire Act provides for all seven of these characteristics; the Massachusetts Act provides for only six.

STATUTORY CHARACTERISTIC	IS THE CHARACTERISTIC PROVIDED FOR IN THE NEW HAMPSHIRE ACT?	IS THE CHARACTERISTIC PROVIDED FOR IN THE MASSACHUSETTS ACT?
1. LLCs are legal entities independent of their members.	Yes	Yes
2. LLCs may have any number of members but must have at least one.	Yes	Yes
3. LLCs provide their members with statutory liability shields.	Yes	Yes
4. Multi-member LLCs provide their members with the special LLC statutory business asset protections known as "charging order protections."	Yes	Yes
5. LLCs may have either of two management structures—management by the members or management by persons appointed as managers	Yes	Yes
6. LLCs impose very few statutory formalities on their members regarding voting, meetings and other matters.	Yes	Yes
7. The courts must give great deference to the contractual arrangements among the members of an LLC.	Yes	No express provision

The last of the above seven statutory characteristics—namely, that concerning contractual freedom and enforceability—is discussed in greater detail in paragraph 7(a) of this newsletter.

4) Mergers and conversions. Every soundly drafted LLC act should enable business people (a) to merge non-LLC entities (e.g., corporations) into LLCs and vice versa; and (b) to make "statutory conversions" between non-LLC entities and LLCs. (In a statutory conversion, an entity changes its business organization form—e.g., from the corporate to the LLC form—but remains the same entity before and after the conversion. Statutory conversions provide many legal and tax advantages that mergers do not provide.) Both the New Hampshire and the Massachusetts Act contain easy-to-use merger and conversion provisions.

5) Financial provisions. The financial provisions of the New Hampshire and Massachusetts Acts are essentially identical. Both acts provide that unless the

agreement among the members provides otherwise, an LLC's allocations of its profits and losses among its members and its distributions of its profits and other assets to the members must be proportionate to the members' respective shares of LLC contributions.

6) Do operating agreements have to be in writing? Under the New Hampshire Act, an LLC agreement is not valid unless it is in writing. Under the Massachusetts Act, operating agreements (the Massachusetts term for LLC agreement) are valid even if they are merely oral.

   However, not only under the New Hampshire Act but also under the Massachusetts Act, LLC members should always have written agreements defining their respective rights, duties and liabilities. Among other considerations, these agreements are necessary in order to alter LLC statutory default rules that don't work in the deal in question. In both the New Hampshire and the Massachusetts Act, there are many default rules potentially inappropriate in particular deals.

   In addition, under both the New Hampshire and the Massachusetts Acts, written agreements are necessary to address any disputes that may arise among the members about matters not covered by statutory default rules, such as disputes about member buy-outs and about alleged member and manager fiduciary breaches.

7) Case law. There are eight reported cases under the Massachusetts Act; there is only one under the New Hampshire Act. However, all of these cases deal with facts that are unlikely to be relevant to any LLCs except those named as parties in the cases. Thus, the fact that there is more LLC case law under the Massachusetts Act than under the New Hampshire Act is unlikely to be relevant in helping clients to choose between the two acts.

8) Significant differences between the two acts. In choosing between the New Hampshire Act and the Massachusetts Act, clients and their lawyers and accountants should be aware of six main differences between these acts:

   a) Freedom and enforceability of contracts. The New Hampshire Act contains a provision specifically providing, in effect, that the courts must give maximum deference to the arrangements of the parties in their LLC agreement and must enforce these arrangements except in extreme cases. The Massachusetts Act contains no such provision. Thus, the New Hampshire Act provides LLC organizers and members with greater contractual flexibility and certainty than the Massachusetts Act.

   b) Fiduciary provisions. The Massachusetts Act contains no fiduciary provisions whatsoever concerning the duties of care and loyalty and other fiduciary matters. The New Hampshire Act contains at least a few such provisions. Thus, in the event of a fiduciary dispute among LLC members, the New Hampshire Act will provide significantly more guidance than the Massachusetts Act.

      However, in view of the great importance of fiduciary rules in multi-member LLCs, persons forming LLCs under either act should not put their faith in statutory provisions or even in case law; rather, they should comprehensively address fiduciary issues in written agreements.

c) Events of dissociation. The Massachusetts Act provides virtually no guidance about the types of events—referred by LLC practitioners as "events of dissociation"—that will cause members to lose their management rights. (Typical events of dissociation include death, disability, resignation and bankruptcy.) The New Hampshire Act provides substantial guidance about these events. However, as in the case of fiduciary duties, prudent LLC organizers and members, whether they are forming their LLC under the New Hampshire Act or the Massachusetts Act, will want to address these events comprehensively in a written agreement.

d) Delegations. The Massachusetts Act expressly permits its members and managers to delegate their power and authority to other persons. Whether such delegations are valid under the New Hampshire Act is ambiguous. In a large LLC with numerous employees and complex operations, this ambiguity in the New Hampshire Act can be a problem.

e) Right of non-manager members to participate in LLC management. The provisions of the Massachusetts Act suggest that members who are not expressly endowed with management authority in manager-managed multi-member LLCs may have less opportunity to participate in their LLC's management than is possible under the New Hampshire Act.

f) Personal liability of members and managers for breaches of their LLC duties. The Massachusetts Act permits LLC members to eliminate the personal liability of members and managers for breaches of their fiduciary duties. The New Hampshire Act is significantly less permissive than the Massachusetts Act in reducing or eliminating members' and managers' personal liabilities for these breaches.

CONCLUSION

On the basis of the above discussion, it can be argued that, in general, the New Hampshire Act is likely to be superior to the Massachusetts Act in many LLC deals, particularly with respect to the fundamental issue of contractual freedom and enforceability. However, both acts have significant flaws; and in any event, the organizers of LLCs that involve significant financial or personal stakes should not rely on statutory provisions, but rather, should address all legal and tax issues likely to be relevant to them in comprehensive written agreements. Through these agreements, they can tailor their LLCs under both the Massachusetts and the New Hampshire Acts and, effectively, can write their own legal and tax rules.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 44 (JUNE 25, 2007)

WHAT FEDERAL TAX PROVISIONS SHOULD BE INCLUDED IN THE LLC AGREEMENTS OF MULTI-MEMBER LLCs TAXABLE AS PARTNERSHIPS—AND WHY?

EXECUTIVE SUMMARY

Before you can decide what federal tax provisions should be included in the LLC agreement of a multi-member LLC taxable as a partnership, you should define the purpose (or purposes) of these provisions; and you should include in the agreement all of the provisions—and only the provisions—that are necessary to fulfill these purposes.

DISCUSSION

About half of all LLCs are multi-member LLCs—i.e., they have two or more members. A very substantial majority of these multi-member LLCs are taxable as partnerships under Internal Revenue Code Subchapter K. As every accountant knows, Subchapter K is one of the most complex parts of the Internal Revenue Code, and the federal tax provisions in many LLC agreements—including even the very large number of those LLCs that have very simple economic and tax arrangements—can be dauntingly complex. Indeed, the "tax boilerplate" in these agreements—often inserted by lawyers in LLC agreements without any understanding of what it means—is likely to be unintelligible to anyone except a partnership tax specialist.

In future issues of this newsletter, I will write about the various specific federal tax provisions that I believe should be in the LLC agreements of LLCs taxable as partnerships. However, it is obvious that the starting point in identifying these provisions must be to determine the *purposes* that these provisions should fulfill. I suggest that there are five such purposes.

1) The federal tax provisions of the LLC agreement of an LLC taxable as a partnership should state the tax deal in a manner that is accurate, comprehensive and legally enforceable in court. Thus, for example, in those few cases where one or more members want "special allocations"—i.e., allocations of income, losses or other tax items disproportionate to their share of aggregate contributions or capital accounts or otherwise inconsistent with their interest in the LLC—these special allocations should be accurately stated.

2) To the extent possible, the federal tax provisions of the LLC agreement should be such as to enable the members to understand the economic and tax deal and to make sure the deal is what they want. In general, this means that all tax and economic terms should be stated as clearly as possible and that any tax terms whose meaning isn't likely to be clear to the members are defined in plain English (and explained verbally to the members by their legal and tax professionals if necessary or helpful). It also means that the agreement should not contain abstruse tax boilerplate that the members won't understand unless this boilerplate is absolutely necessary to the deal.

3) The federal tax provisions of the LLC agreement should be such that, if an IRS agent or state tax official ever audits the LLC, they will give the official an initial sense that the LLC is probably complying with applicable tax rules. To achieve this effect, the LLC agreement should contain, among other things, clearly stated rules for the maintenance of capital accounts and for the liquidation of the LLC in accordance with capital accounts. Furthermore, much as I hate to admit it, the agreement should generally contain a "qualified income offset" provision (a "QIO"), since, whether reasonably or not, tax officials generally expect to find such a provision in the agreement or, in its place, they expect to find a "deficit restoration obligation" (a "DRO"). (I'll explain the meaning of the quoted terms in a soon-forthcoming issue of this newsletter.)

4) The federal tax provisions of the LLC agreement should provide clear guidance to tax accountants and other tax advisers as to how to answer members' partnership tax questions after the LLC begins business and as to how to prepare tax returns for the LLC. Thus, for example, if a member has contributed to the LLC real property with a built-in pre-contribution gain, the LLC agreement should make clear that tax accounting for the LLC must follow the regulations under IRC Section 704(c)(1)(A) and, in particular, the agreement should specify which of the three allocation methods under those regulations—the "traditional method," the "traditional method with curative allocations" or the "remedial method"—should be used to do tax accounting in respect of the property.

5) The federal tax provisions in the LLC agreement should be such as to maximize tax compliance by the LLC and its members. In my view, this means that the agreement should, among other things, require the members (a) to appoint a tax adviser who is reasonably expert in partnership taxation; and (b) to consult with this adviser before undertaking any major LLC transaction (such as a sale or issuance of an LLC membership).

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 45 (JULY 13, 2007)

DEMYSTIFYING LLC PARTNERSHIP TAXATION—THE CONCEPT OF THE "STRAIGHT-UP PARTNERSHIP"

EXECUTIVE SUMMARY

The key to understanding how to draft and review federal tax provisions in LLC agreements of LLCs taxable as partnerships is to understand the concept of the "straight-up partnership." Partnership tax can be very complicated, but straight-up partnerships are simple.

DISCUSSION

As discussed in last month's newsletter, about half of all LLCs are multi-member LLCs, and, for better or worse, most multi-member LLCs are subject to the default federal tax regimen of partnership taxation under Internal Revenue Code Subchapter K. (As readers will know, I believe that many multi-member LLCs should instead be taxable as S corporations.)

As all accountants are aware, partnership taxation can be very complex; but the basic federal tax framework of LLCs taxable as partnerships is simple—it is the framework of a "straight-up partnership." In this framework, the members' respective shares of contributions to the LLC determine their allocations of LLC profits and their distributions of LLC cash and other assets; and the tax structure of the LLC is identical to its economic structure. I contribute one third of the LLC's cash; and I get a third of its allocations and distributions. Period.

My rough guess is that at least 90% of all LLCs taxable as partnerships are straight-up partnerships and that, accordingly, they need only the contribution, allocation and distribution provisions that I've just described. And part of the beauty of these provisions is that you don't have to be a CPA or to have a master's degree in taxation to understand them. On the contrary, they can be understood by any business person with a college (or, for that matter, a high school) education.

The above brief description of the tax provisions in the LLC agreement of an LLC taxable as a straight-up partnership requires only two important qualifications:

- The "Prop. Reg." If most of the members of a particular multi-member LLC are passive investors but one of them is also an LLC manager and wants to avoid Social Security Taxes (called the "Self-Employment Tax" (the "SET") in the case of partnerships), the LLC agreement of the LLC should contain not only the straight-up partnership provisions described above but also a small number of

specialized provisions required for compliance with IRS LLC SET-avoidance rules. These rules are set forth in an IRS proposed regulation designated Prop. Reg. § 1.1402(a)-2 (the "Prop. Reg."). In essence, the Prop. Reg. requires that the LLC agreement provide for two separate classes of interests—an investor class, in which all of the members will participate; and a manager class, in which only the managers will participate. This simple structure can save LLC member-managers thousands of dollars a year in SET liabilities.

- <u>Special allocations</u>. In addition, if any of the members successfully negotiates for "special allocations" of particular types of tax deductions or other tax items, the LLC agreement, although its principal tax provisions will be straight-up partnership provisions, must also contain specialized provisions that mirror "safe harbor" IRS regulations governing special allocations. (Special allocations are allocations that differ from the basic interest of the partners. For example, a member of an LLC taxable as a partnership who, in general, is entitled to one third of the LLC's profits might negotiate to obtain a special allocation of *all* of the LLC's tax credits.)

  Thus, if a member is entitled to special allocations relating to deductions in respect of LLC real property purchased with the proceeds of a non-recourse loan (i.e., a loan secured only by the property itself and not by other assets of the LLC or the members), the basic tax provisions of the LLC agreement will still be straight-up partnership provisions, but the agreement will also contain "plug-in" provisions concerning partnership non-recourse debt, partnership minimum gain, partner minimum gain and partnership and partner minimum gain charge-backs.

However, in many LLC agreements for multi-member LLCs, the above Prop. Reg. provisions won't be needed; in most such agreements, the above special allocations won't be needed; and the straight-up partnership provisions in all of these agreements are a matter of simple economics and, indeed, simple arithmetic.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 46 (AUGUST 3, 2007)

WHAT EVERY ACCOUNTANT SHOULD KNOW ABOUT LLC FIDUCIARY ISSUES

EXECUTIVE SUMMARY

The fiduciary provisions in the LLC agreement of a multi-member LLC are the provisions that determine the ethical rules and the "team spirit" of the LLC. They can play a key role in the success both of small, simple LLCs and large, complex ones. Accountants should make sure that their clients are aware of the importance of fiduciary provisions in LLC agreements that they are asked to sign; and they should urge their clients to ensure that their lawyers in LLC deals, if they have any, properly address these issues on their behalf.

DISCUSSION

As readers will know, the LLC agreements of multi-member LLCs are, in effect, partnership agreements among the members and managers. These agreements determine the legal and tax structures of these LLCs and define the members' and managers' rights, duties and liabilities.

In my experience, the issues that are by far the most likely to be neglected in the LLC agreement of a multi-member LLC are fiduciary issues. (Obviously, fiduciary provisions are *not* important in the LLC agreements of single-member LLCs; in this newsletter, I will be discussing only the LLC agreements of *multi*-member LLCs.)

Fiduciary rules are those that:

- As indicated, determine the ethical standards with which the members and managers of LLCs must comply and the LLC's "team spirit;"
- Define the methods (e.g., arbitration by a single arbitrator) that must be used in resolving fiduciary disputes;
- Define member and manager liabilities, including liability for money damages, for fiduciary breaches;
- Provide, where appropriate, for advancement of litigation or arbitration expenses to members and managers in fiduciary disputes and for insurance against fiduciary liabilities; and
- Provide, where appropriate, for "exculpation" from fiduciary liabilities (i.e., contractual protection from these liabilities).

My 14 years' experience as an LLC lawyer have taught me that the fiduciary provisions in the LLC agreement of a multi-member LLC are very often the most important of all of the provisions in the agreement; and that the more skillfully these provisions are drafted, the more likely will be the success of the LLC. And in my experience, this truth applies not only in the case of small, simple LLCs with only two or three members and a capitalization of a few thousand dollars but also in the case of large, complex ones with dozens of members and multi-million dollar capitalizations.

In any LLC agreement, it is critical that the fiduciary rules be set forth as comprehensively as possible. Otherwise, if there is a fiduciary dispute among the members, the outcome of the dispute may be impossible to predict and its resolution by a judge or arbitrator may be radically different than that expected by the members. For example, if, in the case of a particular manager-managed multi-member LLC, a court applies the famous ruling of Judge Cardozo in a case called *Meinhard v. Salmon*, the managers of the LLC may find that they are subject to fiduciary duties of extraordinary strictness.

The most familiar fiduciary duties are those of care and loyalty. However, both of these duties can be defined in an LLC agreement in many different ways depending on the needs and interests of the LLC's members and managers.

In addition, there are many other types of fiduciary and "quasi-fiduciary" duties that also need to be defined in detail in LLC agreements and tailored to the parties' needs. These include the duty of disclosure (i.e., the affirmative duty of the members and managers to be honest with one another and to take the initiative to disclose to one another information relevant to the LLC); and duties of good faith, fair dealing, cooperation and compliance with relevant legal and ethical standards.

If you are an accountant but don't also have a law degree, you may be hesitant to raise the issue of fiduciary duties with clients of yours who are considering participation in LLC deals. However, I can assure you that you will not be engaging in the unauthorized practice of law if you merely advise these clients to make sure that the fiduciary provisions in any LLC agreement they are asked to sign are in their best interest; and you may even want to give these clients a copy of this newsletter.

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 47 (SEPTEMBER 17, 2007)

SHOULD THE NEW HAMPSHIRE LIMITED LIABILITY COMPANY ACT BE AMENDED (AND SHOULD ACCOUNTANTS CARE)?

EXECUTIVE SUMMARY

The New Hampshire Limited Liability Company Act (the "LLC Act") is a basically sound LLC statute. However, it needs numerous significant amendments, and some of these amendments—especially those relating to tax distributions and member buy-outs upon death—can provide important financial and tax benefits to the LLC clients of New Hampshire accountants.

DISCUSSION

I. INTRODUCTION

The LLC Act was originally enacted in 1993, and the New Hampshire legislature made major amendments to it in 1997 to take advantage of the substantial flexibility available to LLCs and their members under the U.S. Treasury Department's newly issued "Check-the-Box" federal tax classification regulations (which became effective on January 1, 1997).

Significant usage of the LLC business organization form began in New Hampshire only in 1997. However, in recent years LLCs have all but replaced corporations, limited partnerships and all other statutory business organization forms as the entities of choice for New Hampshire business start-ups.

In addition, in recent years, many New Hampshire corporations and other non-LLC entities have converted to LLCs in order, among other things, to obtain the unique legal advantages available to LLCs and to provide their owners with protection from the New Hampshire Interest and Dividends Tax. (The I&D Tax applies to all New Hampshire residents who are shareholders of corporations but not to members of LLCs that are properly structured).

According to statistics compiled by the Corporate Division of the New Hampshire Secretary of State, there are now about 31,000 New Hampshire LLCs, as compared with only about 19,000 New Hampshire corporations, and seven new LLCs are being formed under the LLC Act for each corporation formed under the New Hampshire Business Corporation Act.

Since 1997, New Hampshire business people, accountants and lawyers have had extensive experience in forming and operating LLCs. In addition, in 2006, the National

Conference of Commissioners for Uniform State Laws approved the Revised Uniform Limited Liability Company Act (nicknamed "Re-ULLCA") and published with that model act extensive comments on its provisions. These comments constitute a virtual encyclopedia of state-of-the-art learning about the LLC form.

Thus, the time is ripe for New Hampshire business people, accountants and lawyers to review their experience with LLCs under the LLC Act and to decide whether that act needs amendment.

II. LEGISLATIVE POLICY CONSIDERATIONS

However, before deciding what, if any, specific amendments should be made to the LLC Act, one must first determine as clearly as possible the key relevant legislative facts and principles of legislative policy that should guide the amendment process. To me, these facts and principles are very clear:

1) The key legislative facts. We know from the public records of the New Hampshire Secretary of State, from IRS filing statistics and from other evidence that the vast majority of New Hampshire LLCs have only one or two members; that their capitalization is very small; that, for economic and other reasons, their members form them without any assistance from accountants, lawyers or other professionals; and that they rarely have written or oral LLC agreements. (Under the LLC Act, "LLC agreements" are written agreements among the members that determine the legal and tax structures of the LLCs for which they are drafted.)
2) The LLC Act should provide a sound "off-the-shelf" LLC agreement for small, unsophisticated LLCs that have no written LLC agreement. Thus, the key in evaluating the provisions of the LLC Act and in deciding whether amendments are needed is to determine what types of provisions are likely to be best for the above types of LLCs and their members; and the LLC Act should be amended to the extent necessary to provide these provisions. In other words, the LLC Act should be amended so that, to the maximum possible extent, its provisions will constitute an "off-the-shelf" LLC agreement that will meet the needs and expectations of members who do not have written LLC agreements. However, these provisions should, for the most part, be *default* provisions—i.e., provisions that the members can amend in their LLC agreements—so that members (especially those represented by sophisticated accountants and lawyers) can readily amend these provisions in their LLC agreements to fit the specific requirements of their LLC deal.
3) The LLC Act should be drafted so that it can be easily understood not only by business people but also by accountants and lawyers who are not LLC specialists. Because there is far less of a market for sophisticated LLC practitioners in New Hampshire than in many other, larger states, we must presume that most lawyers and accountants who assist in these formations have only a basic understanding of LLC law. Thus, for the sake of LLC business people but also for the sake of their accountants and lawyers, the provisions of the LLC Act should be as direct, intuitive and easy to understand as possible.

III. PROPOSALS FOR SPECIFIC AMENDMENTS TO THE LLC ACT

In my view, the above policy considerations dictate at least a dozen significant amendments to the LLC Act. However, the amendments to that act that I believe are the most important are the four amendments set forth below.

1) Fiduciary amendments. In any small business, it is critical that each owner act as ethically as possible toward the other owners and the business if the business is to succeed. However, the fiduciary provisions of the LLC Act (which, effectively, are the ethical rules with which LLC members must comply in operating their LLCs) are incomplete and many such provisions that the act does contain are insufficiently clear. The LLC Act should be amended to provide clear, comprehensive and stringent provisions concerning members' and managers' fiduciary duties of care, loyalty, confidentiality and candor.

2) Distribution amendments. The LLC Act presently provides, in effect, that LLCs need not make distributions to their members except to the extent that the LLC agreement specifically so provides; and the act implicitly provides that LLC agreements that do not provide for distributions can be amended only with the consent of all of the members. This means that it is often impossible for New Hampshire LLC members who need tax distributions—i.e., distributions of cash to enable them to pay their taxes on their shares of LLC income—to obtain these distributions. The LLC Act should be amended to provide that for tax purposes and otherwise, the LLC must make distributions whenever required by vote of a majority of the members.

3) Voting amendments. The LLC Act presently provides that unless the LLC agreement provides otherwise, each member has one vote on each matter on which the members may vote. However, in my experience, most members of New Hampshire LLCs assume that their voting power will be proportionate to their share of contributions to the LLC. The LLC Act should be amended to meet this expectation.

4) Buy-out amendments. The LLC Act presently provides, in effect, that LLC members who die while they are members will not be entitled to be bought out by the LLC or the other members unless their LLC agreement specifically so provides. However, when members of small LLCs die, these buy-outs may be critically important to support members' survivors. Thus, the LLC Act should be amended to provide that unless the LLC agreement provides otherwise, a member's death will trigger a right on the part of the member's successor to be bought out for fair value (but on terms that will not unduly burden the LLC).

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 48 (OCTOBER 9, 2007)

RECENT AMENDMENT TO NEW HAMPSHIRE WORKERS' COMPENSATION LAW IMPOSES MAJOR NEW BURDEN ON NEW HAMPSHIRE BUILDING TRADES

EXECUTIVE SUMMARY. A recent amendment to New Hampshire workers' compensation law eliminates the ability of New Hampshire corporations and LLCs to exclude key officers and members from workers' compensation coverage. However, it is relatively easy for these companies to convert to New Hampshire limited liability partnerships. This conversion will protect them from the negative financial impact of the amendment.

DISCUSSION. As many readers will know, Section 281-A:18-a of the New Hampshire workers' compensation statute has provided for many years that any corporation or limited liability company is entitled to exclude up to three executive officers or members from the compulsory coverage requirements of the statute. The exclusion provided by Section 281-A:18-a has been of major importance to hundreds of New Hampshire companies engaged in businesses and trades potentially subject to heavy workers' compensation premiums. For some of these companies, the exclusion has meant the difference between business success and business failure.

However, under a major amendment that became effective on September 14, 2007, Section 281-A:18-a has been altered to provide that the above exclusion

> shall not apply to any individual, regardless of status or title within a corporation or limited liability company, *who is actively engaged in on-site work on any construction site within the state of New Hampshire.*
>
> (Emphasis added)

The precise scope of the above amendment is extremely unclear. For example:

- Is a corporate officer or LLC member who engages only in *supervisory* work "actively engaged in on-site work" within the meaning of the amendment?
- What if such an officer or member engages in only a few minutes of physical labor at a construction site during a relevant year? Does this minimal work nevertheless destroy the Section 281-A:18-a exclusion for his or her corporation or LLC?

- Does the amendment apply if the work being done at the site in question is not the construction of a new highway or office building, but rather, a minor project involving residential renovation?

Not only is the amendment to Section 281-A:18-a highly ambiguous; there is a serious question whether it is constitutional, since, among other considerations, it singles out one group of arguably hazardous trades—namely, the building trades—but spares many other trades, such as logging, that are clearly far more hazardous.

Indeed, there is even an indication that the amendment may arise from staff error and may seriously misrepresent the Legislature's intent. This is because HB 471-FN-A, the bill from which the amendment derived, provided for elimination of the above exclusion only for corporations and LLCs doing work at New Hampshire *state* construction sites. By its terms, amended Section 281-A:18-a applies to *all* New Hampshire construction sites.

In my view, there are four main alternatives available to corporations and LLCs to avoid the potentially lethal impact of the amendment. I suspect the first three of these alternatives will be unattractive to some of these entities; but for many of them, the fourth may be highly practical.

- Litigation. First, as I've indicated, the amendment is open to serious legal challenge in the New Hampshire courts. However, the costs and risks of litigation to overturn the amendment will be prohibitive for most affected companies.

- Lobbying. Second, affected companies, either directly or through trade associations, may contact members of the Legislature to seek repeal of the amendment. However, while I think that ultimately, this approach is likely to succeed, it is unlikely to achieve success for at least a year or two.

- Conversion to sole proprietorship or general partnership form. Third, while New Hampshire workers' comp rules *do* apply to corporations and LLCs, these rules do *not* apply to individuals conducting their businesses as sole proprietorships or to individuals who are partners of general partnerships. Thus, the shareholders of corporations and the members of LLCs may be tempted to consider dissolving these entities and conducting their businesses as sole proprietorships or general partnerships.

  However, as most readers will know, under New Hampshire law, sole proprietorships and general partnerships do not provide their owners with liability shields. In relatively hazardous businesses such as the building trades, business owners should think long and hard before forgoing these shields; if they forgo them and their businesses thereafter become subject to serious claims, these owners may lose not only their businesses but also their homes and all of their other personal assets.

- Conversion to LLP. Fourth, corporations and LLCs adversely affected by the amendment should consider converting to LLPs. LLPs are general partnerships that file registrations as LLPs with the New Hampshire Secretary of State. This registration provides a general partnership with a liability shield that is not as comprehensive as that of LLCs and corporations, since it protects the partners

> only from claims of negligence and similar claims. The LLP does *not* protect partners from, for example, from claims under contract law, bankruptcy law, environmental law or sexual harassment law. However, the main legal concern of most New Hampshire business owners engaged in the building trades is negligence. As a practical matter, the LLP liability shield is all that many of these business owners will ever need.

It is true that in order for an entity to register as an LLP, it must first qualify as a general partnership—which means that it must have at least two owners. However, I suspect that most owners of single-shareholder corporations and single-member LLCs who decide to avoid the effect of the above workers' comp amendment by converting to LLPs will have little difficulty persuading a spouse or close friend to serve as an "accommodation" second owner.

Furthermore, under New Hampshire law, it is relatively easy for corporations and LLCs to convert to or merge into general partnerships—which may then file LLP registrations with the Secretary of State.

To sum up: The September 14, 2007 amendment to RSA 281-A:18-a will impose heavy new workers' comp premium obligations, potentially amounting to thousands or even tens of thousands of dollars, on many New Hampshire corporations and LLCs engaged in the building trades. However, these companies can lawfully avoid these burdens by converting to New Hampshire LLPs.

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.

JOHN CUNNINGHAM

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 49 (OCTOBER 12, 2007)

FOUR QUESTIONS PEOPLE ARE ASKING ABOUT CONVERSIONS OF CORPORATIONS AND LLCs TO LIMITED LIABILITY PARTNERSHIPS TO AVOID WORKERS' COMP COVERAGE

Dear subscribers to my LLC newsletter:

As many of you will know, this morning I distributed a newsletter about the substantial new workers' comp burdens that are being imposed on many New Hampshire companies in the building trades as a result of an amendment to RSA 281-A:18-a (which I'll refer to here as the "Amendment"). I stated in that letter that these corporations and LLCs can avoid the effect of the Amendment if they convert to limited liability partnerships ("LLPs"). Many subscribers have sent me questions about my newsletter by e-mail or phone. Set forth below are:

- The four principal questions people are asking me; and
- My answers to these questions.

1) ***If I convert my corporation or LLC to an LLP in order to avoid the effect of the Amendment, how do I know that the New Hampshire Legislature won't just amend New Hampshire workers' comp law again next year to cover sole proprietorships and general partnerships (including LLPs)?***

There can be no guarantee that the Legislature won't make these further amendments next year. However, there is already widespread and vociferous opposition to the Amendment, and there is a strong lobbying movement underway to repeal it. My bet is that as a result of all of this legislative activity, the Legislature won't want to expand the Amendment; and I'm even inclined to believe that it will repeal it.

Furthermore, if it costs a corporation or LLC legal, accounting and other expenses of, say, $1,500 to convert to an LLP in 2007 and the Legislature does make the above amendments in 2008, the corporation or LLC will still be ahead of the game if the workers' comp premiums it saves in 2007 as a result of its conversion exceed the above expenses.

2) Is it possible that if my corporation or LLC converts to an LLP to avoid the effect of the Amendment, the New Hampshire Department of Labor (the "DOL") will nevertheless be able to impose workers' comp coverage on the ground that the conversion is a sham?

There is no authority directly on point regarding this question. However, I am confident that the answer is no.

- Companies have the right to choose any business organization form they want for the conduct of their business, and, in particular, to choose the form that will provide them with the greatest business, legal and tax advantages. I'm not aware of any federal or state tax authority that has succeeded in disregarding such a choice as a sham, and I doubt the DOL will attempt such a ploy.

  For example, many New Hampshire corporations have converted their business organization form to that of an LLC in order to obtain "charging order protections," which are powerful statutory business asset protections that are provided by LLCs but not by corporations. To my knowledge, no federal or state tax or legal authority has ever tried to challenge these conversions. It should be noted that LLPs, like LLCs, provide charging order protections; and they also provide various other legal advantages that corporations don't provide.

- LLCs, too, have the right to change their business organization form for valid business, legal and tax reasons. One advantage of the LLP form over the LLC form is that, since LLPs are essentially traditional general partnerships with a liability shield, they are covered by a vast body of partnership law—e.g., a classic partnership case by Justice Cardozo called *Meinhard v. Salmon*—on which LLPs may or may not be able to rely.

3) **My corporation is an S corporation (or a C corporation) for federal tax purposes. What will happen to its federal tax status if it converts to an LLP?**

There is no federal tax authority directly on point on this question. However, it is absolutely clear under Internal Revenue Code Section 361(a)(1)(F) that if you convert your corporation to an LLC, this will be a "mere change of form" under that IRC section and that, accordingly, as long as you file an IRS Form 8832 and certain other IRS forms in connection with the conversion, your company's status as a C or S corporation will remain intact—along with its taxable year, its loss carryovers, and any other tax attributes that it may have. (I should note that because I often assist clients in this kind of procedure, I have all of the above forms readily at hand.)

4) **My LLC is an S corporation (or a C corporation) for federal tax purposes. What will happen to its federal tax status if it converts to an LLP?**

Same answer as to Question 3.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 50 (NOVEMBER 14, 2007)

CONVERTING LLCs AND CORPORATIONS TO LLPs TO SAVE NEW HAMPSHIRE WORKERS' COMP PREMIUMS: IS THE ADDED LIABILITY RISK WORTH THE SAVINGS?

EXECUTIVE SUMMARY. Corporate and LLC liability shields are stronger than the LLP shield. However, for most owners of New Hampshire corporations and LLCs that convert to limited liability partnerships ("LLPs") to avoid the new workers' comp premiums imposed on their owners, the differences among these shields won't be significant.

DISCUSSION. As many readers will know, the New Hampshire Legislature has recently amended New Hampshire workers' comp law to provide that corporations and LLCs whose owners work at construction sites must pay workers' comp premiums on these owners. As readers may also know, these companies can avoid the effect of the amendment by converting to general or limited partnerships. In addition, by registering with the New Hampshire Secretary of State as LLPs, these general and limited partnerships can obtain liability shields that, like corporate and LLC shields, will protect the personal assets of partners from claims against their business.

However, in deciding whether to make these conversions, owners of New Hampshire corporations and LLCs should be aware that the protection afforded by the LLP liability shield is inferior in certain respects to that provided by corporate and LLC shields. Corporate and LLC shields protect business owners from *every* type of claim against their company—except, of course, claims arising from the negligence or misconduct of the owners themselves as individuals.

The LLP shield protects the partners of general partnerships and the general partners of limited partnerships that register as LLPs from *most* types of claims against their partnerships, including negligence and other misconduct by the other partners, by the LLP's employees, and, with one exception discussed below, by the LLP's independent contractors. (The liability shield of limited partners of limited partnerships is just as strong as the liability shield afforded to shareholders by the corporate shield and to members by the LLC shield. Thus, an LLP registration is not necessary in order to protect limited partners.)

However, there are three specific types of claims from which the LLP shield will *not* protect the partners of New Hampshire general partnerships or the general partners of New Hampshire limited partnerships:

1. Contract claims. The LLP shield will not protect these partners from *contract claims* against their partnerships. These include claims under real property lease agreements, equipment lease agreements, supply agreements and all other types of written and oral agreements. (However, it is probable that they *will* protect these partners from claims

that *appear* to be pure contract claims if these claims are actually based on the alleged contractual duty of the LLPs in question to avoid negligence.)

> EXAMPLE. Under a commercial real estate lease agreement, ABC, a general partnership registered as an LLP, leases its business premises from Realty Corporation. The partners of ABC are not personal guarantors of the lease under this agreement. ABC becomes insolvent and can't pay the rent it owes to Realty Corporation. Realty Corporation can sue ABC for unpaid rent; but it can also sue ABC's partners as individuals.

2. Statutory claims. The LLP shield will not protect partners from claims based on *federal or state statutes*. These include the federal bankruptcy statute and federal and state environmental statutes, civil rights and anti-discrimination statutes. Significantly, they also include the New Hampshire workers' comp statute. Thus, for example, although, under this statute, LLPs do not have to pay workers' comp premiums on their partners, the New Hampshire Department of Labor can sue these partners as individuals if their LLP fails to pay premiums on its *employees* (i.e., people who work for the LLP, and whom it controls, but who are not included among its partners).

3. Claims relating to misconduct by independent contractors performing work that is "peculiarly risky." In general, LLPs and other businesses are not liable for claims based on the negligence or other misconduct of their independent contractors. However, not only LLPs but also their partners as individuals (except limited partners) will be liable for claims arising from negligence or other misconduct by independent contractors whom they hire to do work for them if this work is "*peculiarly risky*."

   Examples of "peculiarly risky" work include blasting; demolition work involving public sidewalks and other public areas (but not demolition where the public is not nearby); gas installation; excavation beyond foundations causing failure of support walls; inspection and maintenance of elevators; use of acetylene torches; and construction of sewer trenches.

As indicated above, I suspect that if the owners of most New Hampshire corporations and LLCs engaged in building or construction trades consider the risks posed to them by the above three gaps in the LLP liability shield, they will conclude that as a practical matter, these risks are minor and are not significant impediments to their converting to LLPs to avoid workers' comp premiums. However, before they make these conversions, they should consider these risks with great care.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 51 (DECEMBER 29, 2007)

PROTECTING MULTI-OWNER REAL ESTATE RENTAL PROPERTY BY OFFLOADING PROPERTY MANAGEMENT SERVICES TO SEPARATE PROPERTY MANAGEMENT ENTITIES

EXECUTIVE SUMMARY. To avoid losing their properties in the event of a negligence suit, New Hampshire individuals and married couples who own multi-owner rental real property generally should not provide property management services relating to these properties except through a separate property management entity.

DISCUSSION

Thousands of New Hampshire husbands and wives own real estate rental property as joint tenants, and tens of thousands of New Hampshire individuals own real estate rental property through trusts, tenancies in common and multi-owner business organizations such as general and limited partnerships, multi-member LLCs and multi-shareholder corporations. For reasons of economy, many of these individuals and joint tenants also perform property management services with respect to their properties. These include repair and maintenance work, capital improvements, and tenant services such as admissions and evictions.

The rules governing real property ownership, including those governing real property negligence liability, vary greatly depending on the specific form of ownership in question. For example, there are vast differences in these rules as applicable to, on the one hand, joint tenancies and, on the other, multi-member LLCs.

However, under an ancient legal rule widely known even today by its Latin name as "respondeat superior" (which means, effectively, "the owner is liable"), if any of the above individuals or either member of any of the above couples are negligent in performing their property management services and the resulting negligence judgment exceeds their liability insurance, a court may impute this negligence to the joint tenants, trust or business entity owning the property and thus may require the sale of the property in satisfaction of the judgment.

> Illustration. Individuals Jones and Smith own a 10-unit apartment building in Manchester as partners in a New Hampshire general partnership. The building is worth $2 million, and it is covered by a $3 million dollar liability insurance policy. To save costs, Jones, who is good with tools, does all the repair and maintenance work on the building. One day, while doing minor plumbing repairs, Jones forgets to fully close a valve, and the resulting leak triggers an electrical fire in which two tenants die. The court imputes Jones's negligence to the Jones-Smith partnership; the deceased tenants' survivors win a $5 million negligence

> judgment against the partnership; and the court orders the partnership to sell the building in satisfaction of the judgment and to transfer the sale proceeds to the survivors.

There is, however, a relatively simple and affordable means that, although not necessarily fool-proof, can go far to prevent the above result—namely, the use of a separate entity to perform the above property management services.

> Illustration. Same facts as above. However, when the partnership owned by Jones and Smith buys the above apartment building, Jones forms a separate single-member LLC to provide repair and maintenance services, and the general partnership enters into a written contract with this LLC under which the LLC has exclusive responsibility for the building's safe maintenance and operation. When the above survivors bring their negligence suit, Jones's interest in the property and all of his other assets will be at risk, but Smith's will not.

In weighing the above factors bearing on whether to use separate property management entities to protect their interests in rental real estate, New Hampshire real estate owners should also consider the following additional factors:

1) Using LLCs as property management entities. For almost all New Hampshire businesses, the legal and tax rules governing LLCs are likely to be superior to those governing non-LLC entities. Thus, individuals and couples who decide to use separate legal entities to perform the above property management services should almost always form them as LLCs.

2) "Every case is different." As I've indicated above, New Hampshire rules determining liability for negligence in respect of real property vary greatly depending on, among other factors, the form of ownership of that property. Thus, real property owners shouldn't form separate property management entities until they've consulted with a lawyer about the specific facts and law relevant to their own situation.

3) Single-owner properties. Individuals who perform property management services in respect of rental real property of which they themselves are the sole owners generally cannot benefit from using separate entities to provide property management services with respect to their properties. This is because if they are negligent in servicing these properties, the victims of their negligence will very probably sue not only their property management entities but also these individuals themselves in their individual capacities. In these suits, both the interests of these individuals in their real property and also all of their other assets will be at risk.

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.

JOHN CUNNINGHAM

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

ISSUE NO. 52 (FEBRUARY 11, 2008)

THE NEW HAMPSHIRE LLC ACT: BAD NEWS FOR LLC MEMBERS WHO LACK GOOD LAWYERS

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

ISSUE NO. 52 (FEBRUARY 12, 2008)

THE NEW HAMPSHIRE LLC ACT: BAD NEWS FOR LLC MEMBERS WHO LACK GOOD LAWYERS

EXECUTIVE SUMMARY. The New Hampshire Limited Liability Company Act (the "New Hampshire Act") is gravely deficient for persons that form LLCs under it without the assistance of competent LLC lawyers. The New Hampshire Legislature should make major amendments of the Act to meet the needs of these persons.

DISCUSSION. I was privileged to be one of the drafters of the New Hampshire Act as originally enacted in 1993 and of the major amendments to it in 1997. I believe that even as currently drafted, the Act has many fine features.

However, in 1993 and even in 1997, the LLC form was new and unfamiliar, and the members of the drafting committee, including myself, could have very little idea of what kinds of New Hampshire people would be likely to use LLCs; whether these LLCs would be large or small; whether they would be simple or complex; what kinds of LLC legal issues would be likely to be important to the members of New Hampshire LLCs; and whether the members of these LLCs would typically use the help of lawyers in forming them.

In recent years, the LLC has virtually replaced all other types of entities as the entity of choice in New Hampshire and nationwide, and we have learned a great deal about New Hampshire LLCs and their members from practice experience, from IRS filing statistics, and from LLC certificates of formation on file with the New Hampshire Secretary of State. In particular, we have learned:

- That most New Hampshire LLCs have only one or two members and very limited initial capital; and
- That at least one-third of all New Hampshire LLCs have been formed without the assistance of lawyers.[7]

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[7] A statistical analysis of the first 500 LLC certificates of formation filed with the New Hampshire Secretary of State in September, 2007, may be found in my website, whose URL is www.llcformations.com, as Item 1 under the button on the website home page marked "LLC Library."

Furthermore, we have come to understand that because of, among other factors, the numerous ownership structures and management structures potentially available to LLC members, LLC law, even in the case of relatively small and unsophisticated LLCs, can be surprisingly complex.

In my view, the above understandings about New Hampshire LLC law and usage lead remorselessly to the following conclusion: The New Hampshire Act should be drafted primarily to meet the needs of New Hampshire LLC members who cannot afford to hire lawyers to help them form their LLCs or who lack the sophistication to recognize their need for these lawyers. (I will refer to these members in the rest of this issue as "unrepresented members.") More specifically, the New Hampshire Act should be drafted primarily to provide an "off-the-shelf" statutory LLC agreement for unrepresented members.

Unfortunately, the New Hampshire Act as presently drafted falls far short of meeting this standard.

To illustrate:

11) The structure and prose style of the New Hampshire Act. Because of its confusing overall structure and the baroque system employed in it for numbering its various provisions, it is often difficult to find sought-for provisions in the Act; and many of these provisions are written in a complex statutory legalese that is difficult not only for non-lawyers but even for LLC specialists to understand. For the benefit of unrepresented members, the Act needs to be radically restructured and it needs to be rewritten in English.

12) Written vs. unwritten LLC agreements under the New Hampshire Act. The New Hampshire LLC Act does not recognize LLC agreements unless they are written, and it provides, in effect, that verbal agreements are legally invalid. Thus, under the New Hampshire Act, even the most carefully negotiated agreements among LLC members will be ineffective if, as is the case with many small and informal LLCs, they are "sealed with a handshake" rather than memorialized in a formal writing.

13) Fiduciary rules under the New Hampshire Act. Sound, comprehensive fiduciary rules are critical for the success of most multi-member LLCs, and especially for relatively small LLCs with less sophisticated members. These rules set the ethical tone and the team spirit of an LLC and often critically affect the level of commitment of its members. However, on almost every key fiduciary issue likely to be important to unrepresented members—e.g., issues of loyalty, care, candor, good faith and fair dealing—the New Hampshire Act is either silent or gravely deficient.

14) Member voting under the New Hampshire Act. The New Hampshire Act provides that votes on LLC matters shall be allocated among the members on a one-member/one-vote basis. However, I suspect that in the experience of most New Hampshire LLC accountants and lawyers, a substantial majority of LLC members—and particularly those in smaller, less sophisticated LLCs—want member votes to be proportionate to member contributions.

15) Distributions of LLC profits under the New Hampshire Act. The New Hampshire Act provides, in effect, that an LLC may make distributions of its profits to its

members only to the extent explicitly required by its LLC agreement. In practice, this means that members who need distributions to cover their taxes on LLCs profits or for unexpected family or personal needs cannot obtain them except by adopting written agreements that provide for them, or by amending LLC agreements that do not provide for these distributions.

How can we solve the serious problems posed by the New Hampshire Act for unrepresented members?

The only solution currently available for unrepresented members is to hire competent LLC lawyers to draft LLC agreements for them. However, for many of these members, this alternative, because of its expense and other factors, is impractical.

Thus, the only real solution is a massive revision of the New Hampshire Act.

I hope to begin the process of developing such a revision during the summer or fall of 2008 and to submit it to the Legislature some months thereafter. If any New Hampshire accountants or lawyers reading this newsletter are interested in assisting me in this process, I will be very grateful to hear from them.

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.

JOHN CUNNINGHAM

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

ISSUE NO. 53 (MARCH 24, 2008)

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.)[8]

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.

[8] 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.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 54 (APRIL 23, 2008)

THE 29 KEY RULES IN THE CHECK-THE-BOX REGULATIONS IN TABULAR FORM

EXECUTIVE SUMMARY. As every tax practitioner is aware, the Check-the-Box Regulations are absolutely central to federal tax practice—and particularly to federal tax practice involving LLCs. Among other things, these regulations determine the types of federal tax regimens potentially available to LLCs and other entities and the procedures they must follow in electing among these regimens.

The rules contained in the Check-the-Box Regulations are clear, but because of their subject matter, they are very numerous. This and the complexity of the numbering system used by the U.S. Treasury Department in drafting federal tax regulations can make it very difficult to locate specific rules in the Check-the-Box Regulations on specific classification issues.

However, on the basis of my own study of the Check-the-Box Regulations, I believe that there are only 29 truly basic rules in them. I also believe that tax practitioners who obtain a solid understanding of these 29 rules will find it relatively easy to find and understand other, more specialized Check-the-Box rules.

The above 29 rules, together with a few preliminary notes are set forth in the table below.

TABLE OF KEY PROVISIONS IN THE ENTITY CLASSIFICATION REGULATIONS , TREAS. REGS. §§ 301.7701-1 THROUGH 4 (THE "CHECK-THE-BOX REGULATIONS")

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TABLE OF KEY PROVISIONS IN THE ENTITY CLASSIFICATION REGULATIONS , TREAS. REGS. §§ 301.7701-1 THROUGH 4 (THE "CHECK-THE-BOX REGULATIONS")

Preliminary notes.

1. Form of citations in the table. The Entity Classification Regulations (referred to here by the name normally applied to them by tax practitioners—i.e., as the "Check-the-Box Regulations") are codified in the Code of Federal Regulations in 26 CFR § 301.7701-1 through § 301.7701-4. Specific provisions of the Check-the-Box Regulations are normally cited as, for example, "§ 301.7701-1(a)." However, for brevity, the citations in the table below will include only the number of the relevant subsection of the regulation in question and not the preceding "§ 301.7701-". Thus, for example, the above § 301.7701-1(a) will be cited in the table simply as "Section 1(a)."
2. Text vs. paragraph in the table. In the table below, quotations of provisions of the Check-the-Box Regulations are within quotation marks; paraphrases of Check-the-Box Regulations provisions are within brackets.
3. Domestic business entity vs. foreign business entity. Section 301.7701-1(d) of the Check-the-Box Regulations provides that business entities will be defined as domestic or foreign as provided in § 301-7701-5. Section 301-7701-5 provides in relevant part as follows:

   > A business entity (including an entity that is disregarded as separate from its owner under §301.7701–2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity (including an entity that is disregarded as separate from its owner under §301.7701–2(c)) is foreign if it is not domestic. The determination of whether an entity is domestic or foreign is made independently from the determination of its corporate or non-corporate classification. See §§301.7701–2 and 301.7701–3 for the rules governing the classification of entities.

4. Definition and federal tax classification of associations. The term "association" is used frequently in the Check-the-Box Regulations but is not defined in those

regulations. Associations have has been defined for federal tax purposes in the relevant case law as "[bodies] of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise." *Hecht v. Malley*, 265 US 144 (1924). Under Internal Revenue Code § 7701(a)(3), "the term ""corporation"" includes *associations*, joint-stock corporations and insurance companies." (Emphasis added.) Accordingly, an entity classified as an association is subject to federal income taxation under IRC Subchapter C unless it is eligible to make an S election and makes this election.

NUMBER OF THE PROVISION IN THIS TABLE	**CITATION TO RELEVANT SECTION OF CHECK-THE-BOX REGULATIONS**	**ISSUE ADDRESSED**	**TEXT OR PARAPHRASE**
1.	Section 1(a)(2) (first and second sentences)	When does a co-ownership arrangement constitute a business entity for federal tax purposes?	"A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co- owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes."
2.	Section 2(a) (first sentence)	What is a "business entity" for federal tax purposes?	"For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code."
3.	Section 2(a) (second sentence)	What is the federal tax classification of business entities with two or more owners?	"A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership."
4.	Section 2(a) (second sentence before semicolon)	What is the federal tax classification of business entities with only one owner?	"A business entity with only one owner is classified as a corporation or is disregarded. . ."
5.	Section 2(a) (second sentence after semicolon)	What is the federal tax treatment of a disregarded entity?	"[If an] entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."
6.	Section 2(b)	When is a domestic business entity classified	[Section 2(b) provides detailed rules for determining whether a domestic entity is a corporation for federal tax

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		as a corporation for federal tax purposes?	purposes. Among the most basic rules are (i) that an entity is a corporation if it is "a business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic;" and (ii) if it is "an association (as determined under § 301.7701-3)." For the definition of an "association," see Preliminary Note 4, above.]
7.	Section 2(b)(8)(i)	When is a foreign business entity classified as a corporation for federal tax purposes?	[Section 2(b)(8)(i) lists 86 specific types of foreign business entities that, except for certain narrow exceptions under Section 2(b)(8)(ii) and (d), are classified as corporations. Under Section 3(a), all other foreign entities are generally classified as associations but may elect to be classified as disregarded entities if they have only one owner and as partnerships if they have two or more owners."
8.	Section 2(c)(1)	What is a partnership for federal tax purposes?	"The term partnership means a business entity that is not a corporation under [Section 2(b)] and that has at least two members."
9.	Section 2(c)(2)(i)	What is a disregarded entity for federal tax purposes?	"Except as otherwise provided in this paragraph (c), a business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner." [The exception to the above rule is for single-owner entities that are banks under federal law.]
10.	Section 3(a) (first sentence)	Which types of business entities are "eligible entities"—i.e., entities that may elect their federal tax classification?	"A business entity that is not classified as a corporation. . . can elect its classification for federal tax purposes as provided in this section. Paragraph (b) of this section provides a default classification for an eligible entity that does not make an election."
11.	Section 3(a) (second sentence, before comma)	What federal tax classifications may be elected by eligible entities with at least two owners?	"An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership."
12.	Section 3(a) (second sentence, after comma)	What federal tax classifications may be elected by eligible entities with only one owner?	"[An] eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner."
13.	Section 3(a) (fourth sentence)	Must an eligible entity make an election if its default federal tax classification is the classification that its owner or owners want?	"[E]lections are necessary only when an eligible entity chooses to be classified initially as other than the default classification provided to it under Section 3(b) [quoted below] or when an eligible entity chooses to change its classification."
14.	Section 3(b)(1)(i)	What is the default federal tax classification	"Except as provided in paragraph (b)(3) of this section [concerning business entities already classified under

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		of a domestic eligible entity if it has two or more owners?	pre-Check-the-Box Regulations], unless [a domestic eligible entity] elects otherwise, [it] is (i) [a] partnership if it has two or more members. . . ”
15.	Section 3(b)(1)(ii)	What is the default federal tax classification of a domestic eligible entity if it has only one owner?	“Except as provided in paragraph (b)(3) of this section [concerning business entities already classified under pre-Check-the-Box Regulations], unless [a domestic eligible entity] elects otherwise, [it] is (ii) [d]isregarded as an entity separate from its owner if it has a single owner.”
16.	Section 3(b)(2)(i)	What is the default federal tax classification of a foreign eligible entity?	“Except as provided in paragraph (b)(3) of this section [concerning business entities already classified under pre-Check-the-Box Regulations], unless the entity elects otherwise, a foreign eligible entity is -- (A) A partnership if it has two or more members and at least one member does not have limited liability; (B) An association if all members have limited liability; or (C) Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.” [Note. Under the above rules, (i) the default classification of a foreign multi-member LLC is that of an association, but, even though all of the members of the LLC have limited liability, the LLC may elect partnership status; and (ii) the default classification of a foreign single-member LLC is that of an association, but, even though the LLC’s member has limited liability, the LLC may elect to be a disregarded entity.]
17.	Section 3(b)(2)(ii)	What is the definition of limited liability for purposes of classifying foreign eligible entities?	[This definition is set forth in the four sentences of Section 3(b)(2)(ii). The first sentence provides that “a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member.”]
18.	Section 3(c)	With what procedural rules must eligible entities comply in making elections under the Check-the-Box Regulations?	[These rules are set forth in Sections 3(c)(1) and (2). In general, the election must be made by filing IRS Form 8832 and will be effective on the date specified in that form; but this date cannot be more than 75 days before the date of filing or more than 12 months after that date.]
19.	Section 3(c)(1)(v)(C)	Must an eligible entity that qualifies to make an S election file and that files an IRS Form 2553 applying to be an S corporation also file a Form 8832?	[Under Section 3(c)(1)(v)(C), the answer is no.]
20.	Section 3(f)(1)	Will a change in the number of owners of an eligible entity classified as association affect the entity’s classification?	“The classification of an eligible entity as an association is not affected by any change in the number of members of the entity.”
21.	Section 3(f)(2) (first sentence)	If the number of owners of a multi-owner eligible entity is reduced to one,	“An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member.”

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		what effect will this have on the entity's classification?	
22.	Section 3(f)(2) (second sentence)	If the number of owners of a single-owner eligible entity classified as a disregarded entity increases, what effect will this have on the entity's classification?	"A single member entity disregarded as an entity separate from its owner is classified as a partnership when the entity has more than one member."
23.	Section 3(g)(1)(i)	If an eligible entity classified as a partnership elects to be classified as an association, what federal income consequences will result?	"If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners."
24.	Section 3(g)(1)(ii)	If an eligible entity classified as an association elects to be classified as a partnership, what federal income consequences will result?	"If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership."
25.	Section 3(g)(1)(iii)	If an eligible entity classified as an association elects to be classified as a disregarded entity, what federal income consequences will result?	"If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association."
26.	Section 3(g)(1)(iv)	If an eligible entity classified as a disregarded entity elects to be classified as an association, what federal income consequences will result?	"If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association."
27.	Section 3(g)(2)	What provisions of the Internal Revenue Code	"The tax treatment of a change in the classification of an entity for federal tax purposes by election under

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		apply in determining the federal tax treatment of an entity that elects to change its classification?	paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine."
28.	Section 4(a)	What is the definition of a trust for purposes of the Check-the-Box Regulations?	"In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."
29.	Section 4(b)	What is the classification of business trusts under the Check-the-Box Regulations?	[Under Section 4(b), these trusts are generally treated as business entities.]

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 55 (AUGUST 8, 2008)

NON-TAX CHOICE OF ENTITY

EXECUTIVE SUMMARY

Non-tax choice of entity is the process by which a lawyer chooses the best type of entity for a client's business on business law grounds rather than tax grounds. As discussed below, the process usually involves just three steps, and each of these steps is usually simple to perform. This newsletter explains the process under New Hampshire law, but the process is essentially the same under the law of Massachusetts and other states.

The bottom line in the process is this: Your clients should almost always form their businesses as single-member or multi-member LLCs.

DISCUSSION

Every business lawyer should be skilled in non-tax choice of entity, and accountants should at least have a basic understanding of the process. The following is a very succinct and schematic outline of the process, but this outline is all you'll need to know in the vast majority of non-tax choice of entity engagements.

1) The stakes in non-tax choice of entity. The stakes in non-tax choice of entity can be high, so these choices have to be made correctly. For example, if (i) a lawyer advises a client to form her business as a corporation; (ii) the business owns valuable business assets; and (iii) there is a major claim against the client for actions unrelated to her business, she may lose these assets, since corporations don't provide a special type of statutory business asset protections called "charging order protections." However, she stands a good chance of keeping them if her business is conducted as a two-member LLC, since two-member LLCs do provide these protections.

2) What types of business entities are available under New Hampshire law? The starting point in non-tax choice of entity is to know the types of available entities in the relevant jurisdiction. In New Hampshire and most other U.S. jurisdictions, there are eight main types of entities:

   a) Sole proprietorships;

   b) Divisions (i.e., administrative units of entities);

   c) "Traditional" general partnerships (i.e., general partnerships that do not register with the New Hampshire Secretary of State as limited liability partnerships ("LLPs"));

   d) LLPs;

e) "Traditional" limited partnerships (i.e., limited partnerships that do not register with the New Hampshire Secretary of State as limited liability limited partnerships ("LLLPs"));

f) LLLPs;

g) LLCs; and

h) Business corporations.

3) Main legal features of New Hampshire business entities for non-tax choice of entity purposes. The main legal features of each of the above types of entities that are likely to be relevant for non-tax choice of entity purposes are the following:

a) Sole proprietorships. Sole proprietorships are very simple and user-friendly, but they don't provide their owners with limited liability or with charging order protections. With rare exceptions, they should only be used by individuals who own single-owner businesses but have no employees.

b) Divisions. Divisions are very simple and user-friendly but they don't provide the entities that operate them with either limited liability or charging order protections.

c) Traditional general partnerships. Traditional general partnerships are also a simple and convenient business organization form, but they don't provide their partners with limited liability.

d) LLPs. LLPs are also simple and convenient, but the limited liability they provide to their partners protects the partners only from claims of negligence and willful misconduct and not from any other types of claims, such as contract and statutory claims.

e) Traditional limited partnerships. Traditional limited partnerships provide statutory charging order protections and they provide limited liability to their limited partners, but they do not provide limited liability to their general partners.

f) LLLPs. LLLPs provide statutory charging order protections and they provide both their limited partners and their general partners with limited liability. However, they are somewhat less flexible than LLCs; they must have at least one general partner and one limited partner in order to exist; and the limited liability they provide to their general partners, like the limited liability provided by LLPs, is only a partial limited liability.

g) LLCs. LLCs provide their members with strong limited liability and with statutory charging order protections; they are the most flexible of New Hampshire business organization forms; their management structure is generally simple and intuitive; they provide strong limited liability; and they can exist with only one member.

h) Corporations. Corporations provide all of their shareholders with limited liability, but not with statutory charging order protections; and their management structure is cumbersome for smaller businesses and can facilitate veil-piercing (i.e.,

plaintiffs' piercing their limited liability and holding shareholders personally liable for corporate debts).

4) The three steps in the non-tax choice of entity process. The three steps in the non-tax choice of entity are these:

   a) Determine the ownership structure of the business in question. Is the owner one individual; one entity; or two or more persons (whether individuals or entities)?

   b) Determine the types of entities available to businesses with that ownership structure.

   c) Determine which of those entities is best for the business in question. The determining factors will almost always be limited liability; charging order protections; and management structure.

5) Types of entities available to single-owner businesses owned by individuals. There are three types of business entities available to single-owner businesses owned by individuals:

   a) A sole proprietorship;

   b) A single-member LLC; and

   c) A single-shareholder corporation.

6) Non-tax choice of entity guidelines for individuals forming single-owner businesses. Individuals who are forming single-owner businesses should never use sole proprietorships unless they have no need either for limited liability or for charging order protections. They should never use corporations if they have a need for charging order protections or a simple management structure. In practice, this means they should almost always form their businesses as LLCs. However, if the owners in question have valuable business assets, they should form their businesses as *two*-member LLCs (ideally, with their spouses as second members), since, for various important legal reasons, multi-member LLCs are much more likely to provide charging order protections than single-member LLCs.

7) Types of entities available to single-owner businesses owned by entities. There are three types of business entities available to single-owner businesses owned by entities:

   a) A division;

   b) A single-member LLC; and

   c) A single-shareholder corporation.

8) Non-tax choice of entity guidelines for entities forming subsidiaries. Entities should not use divisions to conduct any of their lines of business if there is a significant risk that third parties will make claims against any of their lines of business. Because single-member LLCs provide a much simpler management structure than single-shareholder corporations, entities that operate wholly owned businesses should almost always use single-member LLCs, not single-shareholder corporations, to operate each of their lines of business and also to hold valuable business assets.

9) Types of entities available to multi-owner businesses. Multi-owner businesses should never operate as traditional general partnerships because general partnerships provide no limited liability to any of their partners. They should never use traditional limited partnerships because these limited partnerships provide no limited liability to their general partners. They should almost never use LLPs or LLLPs because under New Hampshire law, LLPs and LLLPs provide general partners with only partial limited liability.

   Thus, as a practical matter, there are only two types of business entities available to multi-owner businesses:

   a) A multi-member LLC; and

   b) A multi-shareholder corporation.

10) Non-tax choice of entity guidelines for multi-owner businesses. Multi-member LLCs provide at least as strong limited liability protection as corporations but are also much more flexible and have much simpler management structures. In addition, multi-member LLCs provide charging order protections, which corporations do not provide, and multi-member LLCs have a simpler management structure and provide greater legal flexibility than corporations. For all these reasons, persons forming multi-owner businesses should almost always conduct their businesses as multi-member LLCs rather than as multi-shareholder corporations.

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FOR TAX AND LEGAL PROFESSIONALS

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THE CRITICAL IMPORTANCE OF CORRECTLY CLASSIFYING LLC STATUTORY PROVISIONS FOR PURPOSES OF DOING LLC DEALS

EXECUTIVE SUMMARY

For purposes of properly understanding the potential impact of the provisions of the governing LLC statute in doing an LLC deal, it is critical both to lawyers and to accountants to classify each relevant provision accurately as a definitional, a mandatory, a default or a permissive provision. Making such a classification incorrectly can cause major problems for your clients and, in extreme cases, for you yourself if, because you have made an incorrect classification that results in harm to your client, your client makes an ethics or malpractice claim against you.

DISCUSSION

The basic concepts concerning the above four types of LLC statutory provisions may be summarized as follows:

1) Definitional provisions. As its name implies, a definitional provision is a provision in an LLC act that defines the meaning of a specified term as used in the act. It is important for you to be familiar with the definitional provisions in the LLC act that govern an LLC in a deal in which you are representing a client (a "governing act") because, among other considerations, if, in negotiating and drafting an LLC agreement, you use a term inconsistently with its statutory definition and the term becomes the subject of a dispute, the definition a court imputes to the term may conflict with the meaning that favors your client. Most of the definitional terms in the New Hampshire Limited Liability Company Act (the "New Hampshire Act") are in Sections 1, I through 1, XIII. An example of a definitional provision in the New Hampshire Act is Section 1, III, which provides as follows:

   > III. "Contribution" means any cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to perform services, that a person contributes to a limited liability company in his capacity as a member.

2) Mandatory provisions. A mandatory provision in an LLC act is a provision that the parties to an LLC deal may not validly alter in an LLC agreement. It is important that you be familiar with the mandatory provisions of a governing act because, if you include a term in the relevant LLC agreement that conflicts with such a mandatory provision, the latter provision will prevail and may be construed in a manner harmful to your client.

3) An example of a mandatory rule in the New Hampshire Act is Section 37, I, which provides as follows:

A promise by a member to contribute to the limited liability company is not enforceable unless set forth in a writing signed by the member.

4) You can usually determine that a particular LLC statutory provision is mandatory from the simple fact that, as in Section 37, I, the provision is unqualified and contains no qualifying phrase such as "unless otherwise provided in the limited liability company agreement." However, sometimes a mandatory rule is hidden in a rule that appears to be a definitional or a default rule. For example, Section 1, VI of the New Hampshire Act provides as follows:

   VI. "Limited liability company agreement" means a *written* agreement of the members or a document adopted by the sole member as to the affairs of a limited liability company and the conduct of its business. (Emphasis added.)

5) The fact that the above section is contained in Section 1 of the New Hampshire Act, whose caption is "Definitions," strongly implies that it is merely a definitional provision. However, it is clear from a careful reading of Section 1, VI that the section also contains an implicit but important mandatory rule—namely, that LLC agreements cannot be valid *unless they are in writing*.

6) Default provisions. A default provision is a provision which imposes a statutory rule on LLCs or their members or managers but which permits the parties to alter that rule in their LLC agreement. Default provisions can be either express or "covert." To the extent that the members of an LLC do not alter a default rule in their LLC agreement, they will be bound by that rule.

7) Express default provisions normally begin with the phrase "unless otherwise provided in a limited liability company agreement" or a similar phrase. Covert default provisions do not contain such a phrase.

8) It is important for you to be familiar with all of the default provisions in the governing LLC act because if the rule contained in any of these provisions is contrary to your client's best interest, you must seek to expressly alter it in the LLC agreement. Otherwise, the default rule will govern the LLC. In addition, if, on a particular issue, a particular default rule favors your client, then if you can avoid discussion of the issue during LLC agreement negotiations, this may result in a significant benefit for your client "by default."

9) An example of an *express* default provision in the New Hampshire Act is Section 42 (first sentence), which provides as follows:

   Except as provided in a limited liability company agreement, a member, regardless of the nature of the member's contribution, has no right to demand and receive any distribution from a limited liability company in any form other than cash.

10) An example of a *covert* default provision in the New Hampshire Act is Section 40, which provides in relevant part as follows:

   [T]o the extent and at the times or upon the occurrence of the events specified in the limited liability company agreement, a member is entitled to receive from a limited liability company distributions before cessation of the member's

membership pursuant to RSA 304-C:27 and before the dissolution and winding up of the limited liability company.

11) In my view, the above provision must be interpreted as providing that unless the limited liability company agreement of an LLC expressly provides for interim provisions of its profits (i.e., distributions other than liquidating distributions), no member is entitled to any such distribution. Obviously, Section 40 is a very dangerous section for members of LLCs taxable as partnerships or S corporations to the extent that these members need interim distributions to enable them to pay federal and state taxes on their shares of LLC income.

12) Permissive provisions. A permissive provision is one that expressly permits a specified arrangement in an LLC agreement but does not require the arrangement. It is important for you to be familiar with the permissive provisions of the governing LLC act because (i) these provisions often provide valuable suggestions as to the content of the LLC agreement in question; and (ii) they provide a solid basis for providing opinions to your clients and third parties (e.g., third-party lenders) about the validity of significant arrangements in that agreement.

13) An example of a permissive provision in the New Hampshire Act is Section 36, I, which provides as follows:

> I. The contribution of a member to a limited liability company may be in cash, property or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

Conclusion. If you understand the above concepts concerning definitional, mandatory, default and permissive provisions in LLC statutes, you will have sound basic equipment for classifying most of the statutory terms in a governing act that are likely to be relevant to LLC formations.

However, under most LLC acts, there are bound to be at least a few terms to which the concepts apply only imperfectly. This is due partly to ambiguities inherent in the English language. For example, in particular circumstances, the seemingly permissive term "may" in a particular LLC statutory provision may function like "shall."

Furthermore, as already indicated above in the case of Section 1, VI, the same provision in an LLC act may implicitly contain two or more types of provisions—for example, a definitional provision and a mandatory provision.

In future issues of this newsletter, I will address from time to time specific provisions of the New Hampshire Act that illustrate the occasional inadequacy of the interpretative framework I've outlined above.

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.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 57 (DECEMBER 18, 2008)

WHAT ACCOUNTANTS SHOULD KNOW ABOUT THE FINANCIAL PROVISIONS OF THE NEW HAMPSHIRE LIMITED LIABILITY COMPANY ACT

PART I—Introduction and Overview

EXECUTIVE SUMMARY
There are 25 principal provisions in the New Hampshire Limited Liability Company Act (the "New Hampshire Act") that address basic LLC financial matters involving contributions, allocations, distributions and member buy-outs. Accountants who represent clients forming or operating New Hampshire LLCs should have a reasonably detailed knowledge of all of these provisions and a thorough knowledge of the 13 most important of them.
DISCUSSION

INTRODUCTION

1) Financial vs. non-financial issues in LLC formations and operations. The main reason most LLC members join their LLCs is to make money. Thus, to the extent that these members spend time thinking about the legal structure of their LLC, they are probably thinking about LLC financial rules. And these financial rules, rather than purely legal rules, must obviously be the primary LLC concerns of accountants.

2) The financial provisions of the New Hampshire Act. By my count, there are 186 provisions of the New Hampshire Act that are likely to be significant in the formation and operation of LLCs formed under that Act. Of these 186 provisions, my review indicates that 25 provisions address basic LLC financial issues. All of these provisions are identified in the attached Exhibit A, and this table indicates whether each of these provisions is a definitional, mandatory, default or permissive provision.[9] Accountants who assist clients in forming and operating New Hampshire LLCs must have a solid basic knowledge of all of these provisions, and they must have a thorough knowledge of those provisions whose financial or tax implications are unclear in any significant respect or which contain financial or tax pitfalls for their clients.

3) Paragraphs 4 through 6. The 13 financial provisions of the New Hampshire Act that are likely to be the most important to most LLCs, their members and their managers are summarized in Paragraph 4 of this newsletter. Certain significant financial issues

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[9] The distinctions among the definitional, mandatory, default and permissive provisions of LLC acts and the practical importance of these distinctions are explained in Issue No. 56 of this newsletter. Issue No. 56 is archived in www.llcformations.com.

that arguably ought to be but are not addressed in the Act are addressed in Paragraph 5. Paragraph 6 briefly addresses issues concerning redemption terms and concerning cross-purchases. Future issues of this newsletter will focus on significant financial provisions of the Act whose meanings are unclear or which contain pitfalls.

4) Key New Hampshire Act financial provisions. In my view, the most important financial provisions of the New Hampshire Act are the following:

(1) Section 78,II—mandatory rule providing for freedom of contract and for enforceability of LLC agreements. Section 78, II of the New Hampshire Act provides in essence that members of New Hampshire LLCs shall have maximum freedom of contract in tailoring their LLCs in their LLC agreements to meet their needs and interests, and that the courts must give maximum effect to these agreements.[10] Although Section 78,II makes no specific reference to LLC financial issues, the section by clear implication provides New Hampshire accountants and lawyers with a sweeping charter of creativity in devising and implementing financial arrangements for their clients' benefit. Many of the other provisions summarized below merely implement this manifest intent of Section 78,II.

(2) Section 1,VII—definition of "limited liability company interest." Section 1,VII defines the key New Hampshire Act term "limited liability company interest." Under Section 1,VII, limited liability company interests mean:

(a) The right of members to receive allocations of LLC profits and losses; and

(b) Their right to receive distributions of LLC cash and other assets.[11]

(3) Section 36,I—permissive rule concerning permitted types of contributions. Section 36,I provides that in exchange for their limited liability company interests and their other rights as members of their LLCs, members may make contributions in the form of:

(a) Cash, property, or services; and

(b) Promises to contribute cash, property or services.[12]

(4) Section 24,I—permissive rule concerning classes of members. Section 24,I provides that LLC agreements may provide for two or more classes of memberships. By unmistakable implication, the section permits these classes to provide not only for differing *management* rights but also for

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[10] Section 78,II provides as follows: "It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."

[11] Section 1,IV provides as follows: "'Limited liability company interest' means a member's share of the profits and losses of a limited liability company and a member's right to receive distributions of the limited liability company's assets.

[12] Section 36,I provides as follows: "The contribution of a member to a limited liability company may be in cash, property or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

differing *financial* rights.[13]

(5) Section 38 (first sentence)—permissive rule concerning permitted types of formulas in LLC agreements for allocations of LLC profits and losses. The first sentence of Section 38 provides in effect that in their LLC agreements, LLC members may allocate the profits and losses of their LLCs on the basis of any formula they wish as long as all of them agree on this formula in their LLC agreement.[14]

(6) Section 38 (second sentence)—default rule concerning formulas in LLC agreements for allocations of LLC profits and losses. The second sentence of Section 38 provides that unless the LLC agreement provides otherwise, the profits and losses of an LLC shall be allocated among the members in proportion to the value of their respective contributions of cash, property and services.[15]

(7) Section 39 (first sentence)—permissive rule concerning formulas in LLC agreements for allocations of distributions of LLC profits and losses. The first sentence of Section 39 provides in effect that in their LLC agreements, LLC members may allocate interim distributions to the members on the basis of any formula they wish as long as all of them agree on this formula in their LLC agreement.[16] Thus, for example, even if the LLC agreement of an LLC allocates its profits equally among the members, this agreement may also provide that all interim *distributions* shall be made to a single identified member.[17] Effectively, because of the default rule of Section 40, such an agreement must be read to provide that all other members will receive *no* interim distributions and that the *only* distributions they receive will be *liquidating* distributions.

(8) Section 39 (second sentence)—default rule concerning formulas in LLC agreements for allocations of distributions of LLC profits and losses. The second sentence of Section 39 provides that unless the LLC agreement provides otherwise, interim distributions shall be allocated among the

[13] Section 24,I provides in relevant part as follows: "A limited liability company agreement may provide for classes or groups of members having such relative rights, powers and duties as the limited liability company agreement may provide. . . ."

[14] LLC allocations mean accruals on the books of the LLC of the members' respective shares of LLC profits and losses. In essence, allocations are mere book entries. As noted below, LLC distributions mean a*ctual transfers* of LLC cash or other assets to members in their capacity as members.

[15] Section 38 (second sentence) provides as follows: "If the limited liability company agreement does not [expressly provide for allocations of profits and losses], profits and losses shall be allocated on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned."

[16] Distributions by an LLC mean the LLC's transfer of cash or other assets to its members simply because they are members and not because of, for example, their services to the LLC. Interim distributions mean all distributions except liquidating distributions. Liquidating distributions mean (i) distributions to the members before the liquidation of their LLC; and (ii) distributions by the LLC to a dissociated member to redeem that member's membership rights.

[17] Section 39 (first sentence) provides as follows: "Distributions of cash or other assets of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in the limited liability company agreement."

members in proportion to the value of their respective contributions of cash, property and services to the LLC.[18]

(9) Section 40—default rule concerning the right of members to receive interim distributions. Section 40 of the New Hampshire Act provides in effect that unless the LLC agreement provides otherwise, LLC members shall have no right to interim distributions from their LLC except to the extent required in the LLC agreement.[19]

(10) Section 41 (first clause of first sentence)—default rule concerning the right of dissociated members, upon their dissociation, to receive distributions of amounts allocated to them before their dissociation. The first clause of the first sentence of Section 41 provides in effect that unless the LLC agreement provides otherwise, a member who is dissociated from an LLC (i.e., whose membership is terminated by reason of death or otherwise) will not be entitled to receive distributions of amounts allocated to the member before the member's dissociation.[20]

(11) Section 41 (second clause of first sentence)—default rule concerning the right of dissociated members, upon their resignation, to buy-outs of their membership rights. The second clause of the first sentence of Section 41 provides in effect that unless the LLC agreement provides otherwise, a member that is dissociated from an LLC will have no right to require the LLC to redeem (i.e., to buy out) the member's membership rights.[21]

(12) Section 41 (second sentence)—mandatory rule concerning status of certain dissociated members as "assignees." The second sentence of Section 41 provides in effect that if a member is dissociated from an LLC and is not bought out by the LLC or by the other members, the dissociated member will have the status of an assignee of a limited liability company interest. This means, in effect, that until a dissociated member is bought out, the member will be entitled to receive allocations of LLC profits and losses and distributions of LLC cash and other assets.[22]

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[18] The second sentence of Section 39 provides as follows: "If the limited liability company agreement does not [provide for allocations of distributions], distributions shall be made on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned."

[19] Section 40 provides in pertinent part as follows: "[T]o the extent and at the times or upon the occurrence of the events specified in the limited liability company agreement, a member is entitled to receive from a limited liability company distributions before cessation of the member's membership pursuant to RSA 304-C:27 and before the dissolution and winding up of the limited liability company."

[20] The first clause of the first sentence of Section 41 provides in relevant part as follows: "[A]ny member, upon ceasing to be a member pursuant to RSA 304-C:27, is entitled to receive any distribution to which the member is entitled under a limited liability company agreement. . . ."

[21] The second clause of the first sentence of Section 41 provides in pertinent part as follows: "[U]nless otherwise provided in a limited liability company agreement, the member is not entitled to receive any payment for the value of the member's limited liability company interest as of the date of cessation of membership based upon the member's right to share in distributions from the limited liability company.

[22] The second sentence of Section 41 provides as follows:

> If the member ceasing to be a member receives no payment for the value of the member's interest in the limited liability company, the member ceasing to be a member shall continue to have the

(13) Section 58,II—mandatory rule concerning liquidating distributions. Section 58,II provides, in effect, that in connection with its liquidation, an LLC must first pay its creditors and that, after making these payments, it must then make distributions to the members in accordance with the rules of the New Hampshire Act governing interim distributions.[23]

5) Significant LLC financial issues that the New Hampshire Act does not address. In my view, the significant LLC financial issues that the New Hampshire Act arguably ought to but does not address are as follows:

(1) Definitions. The New Hampshire Act does not define the key financial term "allocation [of profits]"; it provides no definition for the key general term "distribution"; and it provides no definition of the key terms "interim distribution" and "liquidating distribution."

(2) Scope of member redemptions. The New Hampshire Act does not make clear that redemptions of LLC members' rights must be interpreted to include redemptions not only of their limited liability company interests but also of all of their other membership rights (including, for example, voting rights, agency rights, information rights, fiduciary rights and dispute resolution rights).

6) Redemptions and cross-purchases—closing terms, etc. Among the most important provisions in any LLC agreement are those defining the right of members, upon their death or other dissociation, to require the LLC to redeem their membership rights or to require the other members to "cross-purchase" (i.e., to buy out) these rights. Two provisions addressed above—namely, the first and second sentences of Section 41—address in general terms key member issues relating to member redemptions. However, no term of the Act addresses issues relating to the closing of redemptions and other redemption terms; and none addresses any issue related to cross-purchases of dissociated members' membership rights.

However, these issues, by their very nature, normally must be addressed in a significantly tailored manner in order to meet the unique needs and interests of the LLCs and LLC members in question. Thus, they are issues that, in the case of many

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rights of an assignee of a limited liability company interest under RSA 304-C:46, II, subject to the limited liability company's right of offset under RSA 304-C:27, III.

[23] Section 58,II provides as follows:

II. Upon the winding up of a limited liability company, the assets shall be distributed as follows:

(a) Payment, or adequate provision for payment, shall be made to creditors, including, to the extent permitted by law, members who are creditors in satisfaction of liabilities of the limited liability company;

(b) Unless otherwise provided in a limited liability company agreement, to members and former members in satisfaction of liabilities for distributions under RSA 304-C:40 or RSA 304-C:41; and

(c) Unless otherwise provided in a limited liability company agreement, to members first for the return of their contributions and second respecting their limited liability company interests, in the proportions in which the members share in distributions.

LLCs, cannot be meaningfully addressed in an LLC statute, but rather, only in a well-drafted LLC agreement.

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.

EXHIBIT A

TABLE

PRINCIPAL FINANCIAL PROVISIONS IN THE NEW HAMPSHIRE LIMITED LIABILITY COMPANY ACT

Preliminary notes.

1. Overview of table. This table (the "Table") identifies and quotes or briefly summarizes the principal provisions in the New Hampshire Limited Liability Company Act (the "Act") that relate to financial matters. These matters include, for example, contributions by members to their LLCs; allocations of profits and losses and allocations of distributions by LLCs to their members, and interim and liquidating distributions by LLCs to their members. Direct quotes from the Act are indicated in the Table by quotation marks. Paraphrases of provisions of the Act are indicated in the Table by brackets.

2. Abbreviations in table. The following abbreviations in the Table indicate the following types of provisions:

   DFT = definitional provision
   DFT = default provision
   M = mandatory provision
   P = permissive provision

3. References to "this chapter." The phrase "this chapter" in the Table refers to the chapter of New Hampshire statutory law that codifies the Act—namely, Chapter 304-C of Title 28 of the New Hampshire Revised Statutes Annotated.

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
1.	§ 304-C:1,III	DFL	"Contribution"—definition. "'Contribution' means any cash, property, services rendered or a promissory note or other obligation to contribute cash or property or to perform services, which a person contributes to a limited liability company in the person's capacity as a member."
2.	§304-C:1,VII	DFL	"Limited liability company interest" —definition. "'Limited liability company interest' means a member's share of the profits and losses of a limited liability company and a member's right to receive distributions of the limited liability company's assets."
3.	§304-C:23,III	P	Persons may become members of LLCs without making contributions. "A person may be admitted to a limited liability company as a member of the limited liability company and may receive a limited liability company interest in the limited liability company without making a contribution or being obligated to make a contribution to the limited liability company."
4.	§§ 304-C:24,I & II	P	Classes of members, taking of actions, etc. [These provisions permit LLC agreements to provide for classes of members; for the future creation of classes of members; and for the taking of actions, including the amendment of the LLC agreement, without a vote of a particular class.]

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
5.	§304-C:36,I	P	Permissible contributions. "The contribution of a member to a limited liability company may be in cash, property or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services."
6.	§304-C:37,I	M	Enforceability of promises to make contributions. "A promise by a member to contribute to the limited liability company is not enforceable unless set forth in a writing signed by the member."
7.	§ 304-C:37,II (first sentence)	DFT	Obligation to contribute not affected by death, etc. "Except as provided in a limited liability company agreement, a member is obligated to a limited liability company to perform any enforceable promise to contribute cash or property or to perform services, even if he is unable to perform because of death, disability or any other reason."
8.	§ 304-C:37,II (second sentence)	M	Options available to LLC if a member fails to contribute promised property or services. "If a member does not make [a] required contribution of property or services, he is obligated at the option of the limited liability company to contribute cash equal to that portion of the agreed value of the contribution that has not been made."
9.	§ 304-C:37,III (first sentence)	DFT	Compromises of promises to contribute. "Unless otherwise provided in a limited liability company agreement, the obligation of a member to make a contribution or return money or other property paid or distributed in violation of this chapter may be compromised only by consent of all the members."
10.	§ 304-C:37,III (second sentence)	M	Creditors' rights concerning contributions. "Notwithstanding [a compromise under Section 304-C:37,III (first sentence)], a creditor of a limited liability company who extends credit, or otherwise acts, in reliance on that obligation after the member signs a writing that reflects the obligation and before the compromise, may enforce the original obligation."
11.	§ 304-C:37,IV (first sentence)	P	Penalties for failure to contribute. "A limited liability company agreement may provide that the interest of any member who fails to make any contribution that the member is obligated to make shall be subject to specified penalties for, or specified consequences of, such failure."
12.	§ 304-C:37,IV (second sentence)	P	Types of penalties for failure to contribute. [This provision authorizes LLCs to impose various specified types of penalties on members who fail to make promised contributions.]
13.	§ 304-C:38 (first sentence)	P	Allocations of profits and losses—permissive rule. "The profits and losses of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement."

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
14.	§ 304-C:38 (second sentence)	DFT	Allocations of profits and losses—default rule. "[Unless the limited liability company agreement provides otherwise], [the] profits and losses [of a limited liability company] shall be allocated on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned."
15.	§ 304-C:39 (first sentence)	P	Allocations of distribution—permissive rule. "Distributions of cash or other assets of a limited liability company shall be allocated among the members, and among classes or groups of members, in the manner provided in a limited liability company agreement."
16.	§ 304-C:39 (second sentence)	DFT	Allocations of distributions—default rule. "[Unless the LLC agreement provides otherwise,] distributions of cash or other assets of a limited liability company shall be made on the basis of the value, as of the date of contribution, of the contributions made by each member to the extent they have been received by the limited liability company and have not been returned."
17.	§ 304-C:40	DFT	Members' right to interim distributions. "Except as provided in this subdivision, to the extent and at the times or upon the occurrence of the events specified in the limited liability company agreement, a member is entitled to receive from a limited liability company distributions before [the member's dissociation] and before the dissolution and winding up of the limited liability company." [This section may be read as providing in effect that unless a limited liability company agreement provides for interim distributions, the members shall have no right to these distributions.]
18.	§ 304-C:41 (first clause)	M	Distributions to dissociated members. "Except as provided in this subdivision, [a dissociated member] is entitled to receive any distribution to which such member is entitled under a limited liability company agreement."
19.	§ 304-C:41 (second clause)	DFT	Dissociated member has no right to receive fair value of limited liability company interest, etc. "[U]nless otherwise provided in a limited liability company agreement, [a dissociated] member is not entitled to receive and payment for the value of the member's limited liability company interest as of the date of [dissociation] based upon such member's right to share in distributions from the limited liability company."
20.	§ 304-C:41 (second sentence)	M	Status of dissociated members as assignees with respect to distributions. "If the member ceasing to be a member receives no payment for the value of the member's interest in the limited liability company, the member ceasing to be a member shall continue to have the rights of an assignee of a limited liability company interest under [the Act]."

NUMBER OF PROVISION	CITATION	TYPE	STATEMENT OR PARAPHRASE OF PROVISION
21.	§ 304-C:42 (first sentence)	DFT	Members have no right to non-cash distributions. "Except as provided in a limited liability company agreement, a member, regardless of the nature of the member's contribution, has no right to demand and receive any distribution from a limited liability company in any form other than cash."
22.	§ 304-C:42 (second sentence)	DFT	Right of member to refuse non-cash distributions. "Except as provided in a limited liability company agreement, a member may not be compelled to accept a distribution of any asset in kind from a limited liability company to the extent that the percentage of the asset distributed exceeds a percentage of that asset which is equal to the percentage in which the member shares in distributions from the limited liability company."
23.	§ 304-C:43 (first sentence)	DFT	Status of members as LLC creditors with respect to distributions. "Subject to § 304-C:44 [concerning unlawful distributions] and § 304-C:58 [concerning liquidating distributions], and unless otherwise provided in a limited liability company agreement, at the time a member becomes entitled to receive a distribution, the member has the status of, and is entitled to all remedies available to, a creditor of a limited liability company with respect to the distribution."
24.	§ 304-C:58	M	Liquidating distributions. [This section contains detailed rules governing liquidating distributions by LLCs. The section provides, among other things, that an LLC must pay third-party creditors before making liquidating distributions to members. Although, for convenience, this table identifies the section as containing mandatory rules for distributions to creditors, the section also contains certain default rules relating to non-creditors.]
25.	§ 304-C:78,II	M	Freedom and enforceability of contract. "It is the policy of this [Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 58 (MARCH 4, 2009)

WHAT SHOULD YOU DO IF A PERSON WHO HAS PROMISED TO JOIN YOUR CLIENT'S LLC AND TO MAKE A CONTRIBUTION TO IT RENEGES ON HIS PROMISE?

EXECUTIVE SUMMARY
The best way to avoid the potential disasters that can result if a person promises to join a multi-member LLC but then reneges is for all of the prospective members of the LLC to sign a binding "preliminary LLC agreement" as soon as they reach agreement on the basic terms of the comprehensive agreement. However, if the disaster happens, there is a potential remedy in § 304-C:14,II of the New Hampshire Limited Liability Company Act (the "New Hampshire Act").

DISCUSSION

16) At a meeting among individuals X, Y and Z, X makes a firm verbal commitment to Y and Z that he will join XYZ, a New Hampshire LLC that Y and Z are planning to form; and he promises that, in exchange for one-third of the profits and losses of XYZ and equal voting power with Y and Z, he will contribute $100,000 to XYZ immediately after its formation.

17) However, several days later, when Y and Z ask him to sign the final draft of XYZ's LLC agreement and make his contribution, X tells them that he's changed his mind and won't sign. XYZ's LLC agreement lists X as a party to the agreement; it provides that each of the parties will be bound by the agreement when all of them have signed it; and it provides that X must contribute $100,000 to XYZ promptly after its formation. However, the agreement does not address the issue of what should happen if a person who has promised to join the LLC thereafter refused to sign the agreement.

18) X's refusal to sign XYZ's LLC agreement is a disaster for Y and Z, since, on the basis of X's clear promise, they have made major commitments with third parties. You are the lawyer for Y and Z. What should you advise Y and Z to do in this situation?

19) The starting point in answering this question is § 304-C:23,I of the New Hampshire Act (which I'll refer to here simply as "§ 23,I"). This section provides in essence as follows:

    a) The prospective members of an LLC may resolve in their LLC agreement the issues as to (i) when a person will be admitted as a member of the LLC in connection with its formation and (ii) under what conditions the person will be admitted.

b) However, if the LLC agreement does not address these issues, then the person will be deemed to be admitted as a member of the LLC on the later of (a) the date of formation of the LLC; and (b) the date on which the person's admission is "reflected in the records" of the LLC.[24], [25]

20) The other key provision in dealing with X's breach of his promise to Y and Z is RSA § 304-C:14,II ("§ 14,II"). This section provides, in essence, that if a person that is "required" to execute an LLC agreement refuses to sign it, any person who is "adversely affected" by the refusal may petition the New Hampshire Superior Court to order the person to sign it.[26] Here, Y and Z are clearly "adversely affected" by X's refusal to sign XYZ's LLC agreement. The courts will have to tell us the precise meaning of the word "required" in § 14,II. However, I believe that a person becomes "required" to sign an LLC agreement under the section not only if, as in the XYZ case, "adversely affected" persons are injured by their reliance on the defendant's promise but also merely on the basis of the promise itself.

21) Thus, what Y and Z should do in order to force X to fulfill his promise to them is to seek a Superior Court order under § 14,II directing X to sign the LLC agreement. Once X complies with the order, he will also be bound to make his $100,000 contribution, and Y and Z will avert the above disaster.[27] And if he refuses to sign the agreement, he will be in contempt of court.

22) The great value of § 14,II is that it overrides the normal equitable rule that judges will not issue "injunctions" against a defendant—i.e., they will not order the defendant to do something or to refrain from doing something—if the defendant's misconduct in question can be remedied by money damages. In the XYZ situation, the issue whether money damages may be an adequate remedy for Y and Z may be very

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[24] Section 23, I provides in its entirety as follows:

> 304-C:23 Admission of Members. –
>
> I. In connection with the formation of a limited liability company, a person acquiring a limited liability company interest is admitted as a member of the limited liability company upon the later to occur of:
>
> (a) The formation of the limited liability company; or
>
> (b) The time provided in and upon compliance with the limited liability company agreement or, if the limited liability company agreement does not so provide, when the person's admission is reflected in the records of the limited liability company.

[25] It should be noted that under § 28,I(d) of the New Hampshire Act, there can be no doubt that an LLC agreement is a "record of the LLC" within the meaning of § 23,I(b) (second clause).

[26] Section 14,II provides in its entirety as follows:

> 304-C:14 Execution, Amendment or Cancellation by Judicial Order. –
>
> II. If a person required to execute a limited liability company agreement or amendment of such an agreement fails or refuses to do so, any other person who is adversely affected by the failure or refusal may petition the superior court to direct the execution of the limited liability company agreement or amendment of such agreement. If the court finds that the limited liability company agreement or amendment of such an agreement should be executed and that any person required to execute the limited liability company agreement or amendment thereof has failed or refused to do so, it shall order such person to execute such agreement or amendment or enter an order granting other appropriate relief.

[27] Under § 37,II (first sentence) of the New Hampshire Act, members are obligated to perform any enforceable promise to contribute even if they are unable to perform "because of death, disability or any other reason"; and under § 37,III (first sentence), unless the LLC agreement provides otherwise, they can avoid this requirement only "by the consent of all of the members."

unclear. Section 14,II protects Y and Z from having to litigate that issue or to comply with other traditional contract rules that might otherwise apply.

23) I am not suggesting that litigation under § 14,II will provide Y and Z with an easy solution to their problem with X. No matter how strong their case, litigation in the Superior Court may be expensive, protracted and emotionally painful for Y and Z; and they will have to bear the burden of proof in seeking an order against X under the section. If they have no written evidence, meeting this burden may be very difficult.

24) In view of the risks and potentially heavy costs involved in § 14,II litigation, what should you advise clients who are forming a multi-member LLC if, before you are able to provide a final draft of a comprehensive LLC agreement, they advise you that they suspect one or more of the LLC's prospective members may breach their stated commitment to join the LLC? In my opinion, the safest course of action is the following: As soon as the prospective members of the LLC have agreed verbally on the principal terms of the LLC deal, you should draft a "preliminary LLC agreement." This agreement:

    a) This agreement should clearly state these terms, including terms about who will be the members; and about member contributions, allocations, and distributions.

    b) It should require each prospective member to agree to sign the final draft of the comprehensive LLC agreement when it is presented to them for signature unless its terms are materially inconsistent with those of the preliminary agreement.

    c) It should provide that if any irreconcilable conflicts arise among the parties about the terms of the comprehensive agreement, these terms will be determined by an arbitrator.

    In my view, § 1,VI(a)(1) strongly supports the effectiveness of "preliminary LLC agreements" in ensuring that written commitments to join LLCs will be enforceable. Section 1,V(a)(1) provides, among other things, that a person will be bound by an LLC agreement if the person has signed *any* writing (not just the LLC agreement) that evidences the person's intent to join the LLC.[28],[29]

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.

JOHN CUNNINGHAM'S LLC NEWSLETTER

[28] Section 1,VI(a)(1) provides in its entirety as follows:

> A limited liability company agreement *or another written agreement or writing*:
>
> (a) May provide that a person shall be admitted as a member of a limited liability company, or shall become an assignee of a limited liability company interest or other rights or powers of a member to the extent assigned, and shall become bound by the limited liability company agreement:
>
> (1) If such person (or a representative authorized by such person orally, in writing or by other action such as payment for a limited liability company interest) executes the limited liability company agreement *or any other writing* evidencing the intent of such person to become a member or assignee. . . . (Emphasis added.)

[29]

FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 59 (APRIL 21, 2009)

FIVE KEY TABLES YOU NEED IN HANDLING LLC DEALS UNDER THE NEW HAMPSHIRE LIMITED LIABILITY COMPANY ACT

EXECUTIVE SUMMARY

If, whether you are lawyer or an accountant, you assist clients in forming a New Hampshire LLC, you need to make use of four key tables of New Hampshire Limited Liability Company Act provisions in order to handle this task competently. You can print out each of these tables and the master table on which they are based by clicking on the link to my website, www.llcformations.com, and then clicking on the "LLC Library" button on the left-hand navigation bar on the home page of that website. The "Discussion" portion of this newsletter explains why these tables are necessary and how to use them in New Hampshire LLC formations.

DISCUSSION

1) You can't form NH LLCs unless you know the New Hampshire Limited Liability Company Act. It goes without saying that the most important asset of lawyers and accountants in assisting their clients in forming New Hampshire LLCs is their knowledge of the provisions of the New Hampshire Limited Liability Company Act (the "Act") that are relevant to these formations.

   For lawyers, the key provisions of the Act will often be those dealing with management structures, events of dissociation, fiduciary duties and other purely legal issues. For accountants, the key provisions will normally be those relating to financial and tax issues, such as those concerning contributions, allocations, distributions and buy-sells.

   However, neither lawyers nor accountants can limit their knowledge of the Act to just these types of provisions. This is because often what seems to be a purely financial issue in an LLC deal turns out to have hidden but important non-tax ramifications; and what seems to be a purely legal provision turns out to have important financial implications.

   Thus, whether you are a lawyer or an accountant, you must have a *comprehensive* knowledge of the provisions of the Act relevant to LLC formations if you want to assist your clients in LLC formations competently.

2) Categorizing the provisions of the Act. Furthermore, in order to handle LLC formations competently, both lawyers and accountants must know whether each of the above provisions is properly categorized as a *definitional*, a *mandatory*, a *default* or a *permissive* provision, since this knowledge is critical in making proper use of these provisions in LLC formations.

   a) Definitional provisions. Definitional provisions are those that contain statutory definitions of terms employed in the Act. See, e.g., RSA 304-C:1,VII, which

defines the key financial term "limited liability company interest" as used in the Act. It is necessary to know all of these definitional provisions in order, among other things, to refer properly to the concepts to which these provisions refer when you are dealing with LLC formation clients and, if you are a lawyer, when you are drafting LLC agreements.

b) Mandatory provisions. Mandatory provisions are those which the Act does not permit LLC members to alter in their LLC agreement. An example of a key mandatory provision of the Act is contained in RSA 304-C:37,I, which provides that promises to make contributions to LLCs are binding only if they are writing. Obviously, if you are ignorant of this rule in assisting your client in the formation of a New Hampshire LLC, this ignorance can result in disaster if a member of your client's LLC breaches a merely oral promise to contribute to the LLC.

c) Default provisions. Default provisions are those that the Act permits LLC members to alter in their LLC agreements. A key default provision is contained in RSA 304-C:40, which provides, in effect, that members can receive interim (i.e., operating) distributions from their LLC only if their LLC agreement provides for them. Obviously, if your client anticipates that she will need interim distributions from the LLC to cover federal and New Hampshire taxes on her share of LLC profits, she will want to alter this rule in the LLC agreement of her LLC.

d) Permissive provisions. Permissive provisions are those that authorize and validate arrangements in LLC agreements but do not require them. A key permissive provision in the Act is contained in RSA 304-C:7,II(j), which permits LLCs to appoint officers and agents.

3) The need for tables. However, although it is necessary for you as an LLC lawyer or accountant to know all of the provisions of the Act relevant to LLC formations and to know in which of the above four categories each provision belongs, it is the rare lawyer or accountant who can commit all of this knowledge to memory and have all of it immediately available as needed. Rather, most of us can make practical use of this knowledge in planning and negotiating LLC deals and, in the case of lawyers, in drafting LLC agreements only if it is contained in clearly organized tables to which we can refer as checklists.

   Over the past several months I spent many hours compiling a master table of the provisions of the Act relevant to New Hampshire LLC formations and characterizing each of these provisions as definitional, mandatory, default or permissive. Once I completed this table, I used it as the basis for creating four subtables—namely, subtables containing, respectively, all of the provisions in each of these categories; and I posted them on my website at the link listed above. I use these tables religiously in assisting my clients to form New Hampshire LLCs.

   I invite you to download the above five tables from my website and, if you think they are accurate, to use the four subtables as checklists in your own LLC formation practice. I've made the master table available on my website in order to enable you, if you so choose, to check this table against the Act and thus to satisfy yourself that

the table is accurate. Obviously, the above four subtables can only be as accurate as the master table from which they are derived.

Needless to say, if you find any errors in the master table or in any subtables, please let me know and I'll fix them immediately and post revised tables on my website.

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.

JOHN CUNNINGHAM'S LLC e-NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 60 (JUNE 10, 2009)

WHAT NEW HAMPSHIRE ACCOUNTANTS AND LAWYERS FORMING NEW HAMPSHIRE LLCs SHOULD KNOW ABOUT THE CHECK-THE-BOX REGULATIONS —A PLAIN-ENGLISH INTRODUCTION

PART I—THE PURPOSE AND HISTORY OF THE CHECK-THE-BOX REGULATIONS; ITS IMPACT ON LLCS; ITS PRINCIPAL RULES

EXECUTIVE SUMMARY. The U.S. Treasury Department's Entity Classification Regulations, referred to by many federal tax practitioners as the Check-the-Box Regulations, play a crucial role in determining the federal income taxation of New Hampshire business entities, other state-law business entities and their owners. They have also played and will continue to play a major role in the remarkable emergence of the LLC form.

New Hampshire lawyers who handle only non-tax issues in LLC formations should have at least a basic knowledge of the Check-the-Box Regulations, since this knowledge is critical as general background for their LLC formation practice and since it can greatly facilitate discussions with tax specialists about particular LLCs. Accountants and lawyers who handle tax issues in these formations need to understand these regulations comprehensively, since they have a profound and continuing effect on the taxation of LLCs not only under the Internal Revenue Code (the "IRC") but also under the tax laws of most states.

The present issue of this newsletter discusses the purpose and history of the Check-the-Box Regulations, their impact on the LLC business organization form, and the key rules contained in them. Subsequent newsletters will discuss other critical matters relating to the Check-the-Box Regulations.

DISCUSSION

I. THE PURPOSE OF THE CHECK-THE-BOX REGULATIONS

1) In order to understand the purpose of the Check-the-Box Regulations,[30] one must first understand the distinction between:

   a) *Federal tax classifications;* and

[30] For readers who have only a limited knowledge of federal income tax law: The basic federal tax authority is, of course, the Internal Revenue Code, as enacted by the U.S. Congress. The U.S. Treasury Department has issued thousands of pages of regulations under the IRC, and it continues to issue them. The authority of these regulations is in some respects as that of the IRC itself. The Internal Revenue Service also publishes administrative guidelines under the IRC, including, among many other types, "Revenue Rulings" and "Revenue Procedures," that often have substantial authority on the federal tax issues that they address.

b) *Federal income tax regimens*.

2) *Federal tax classifications* are types of entities that have specified business organization law characteristics set forth in U.S. Treasury Department entity classification regulations. The IRC identifies only two such classifications—namely, "corporations" and "partnerships." The Check-the-Box Regulations identifies these and two additional classifications—namely, "associations" and "disregarded entities." An example of a state-law business entity whose federal tax classification under the Check-the-Box Regulations is that of a corporation is an entity formed under a state-law corporate statute.

3) *Federal income tax regimens* are unified sets of IRC rules that govern the federal income taxation of business entities. There are three principal federal income tax regimens—namely, taxation under IRC Subchapter C, Subchapter K and Subchapter S.[31] In addition, various rules under IRC §§ 1 and 2 impose federal income taxes on the income, including the business income, of individuals, and it is convenient to think of these rules as constituting a fourth federal income tax regimen, referred to here as "sole proprietorship taxation." A determination as to which of these regimens governs a particular type of business entity or an individual business person depends upon the federal tax classification of that entity or person.

4) However, the purpose of the Check-the-Box Regulations is not to answer the question as to which types of *federal income tax regimens* are available to business entities classified as corporations; and these regulations *do not* answer this question. To answer the question, we have to look to rules in the IRC.

5) For example, the terms of the IRC provide by implication that entities whose federal tax classification is that of corporations are taxable either as corporations under Subchapter C or under Subchapter S; and Subchapter S provides rules that determine whether a business entity whose default federal income tax regimen is Subchapter C can elect to be taxable under Subchapter S.

6) The IRC section that originally defined the meaning of the classifications of business entities identified in the IRC as "corporation" and "partnership" was § 7701(a). The definitions in this section were—and they remain—at best partial and vague. However, for many years, the deficiencies of the section didn't much matter, since, during this period, most of the business entities subject to IRC taxation were specifically identified as corporations or as partnerships under state law and were self-evidently subject to federal income taxation as, respectively, corporations and partnerships.

7) However, in recent decades, several new kinds of business entities have arisen, including:

[31] The principal IRC rules governing the federal income taxation of business entities classified as corporations are IRC Subchapter C, §§ 301-385; and IRC Subchapter S, §§ 1361-1379. The principal IRC rules governing the federal income taxation of business entities classified as partnerships are set forth in IRC Subchapter K, §§ 701-777. Subchapter C is a double-tax regimen that imposes a tax on business entities taxable as C corporations and then on their stockholders when they receive dividends from them. Subchapter S and Subchapter K are pass-through tax regimens that, with a few narrow exceptions, impose taxes only on the owners of, respectively, S corporations and entities taxable as partnerships.

a) Single-member LLCs;

b) Multi-member LLCs;

c) Limited liability partnerships;

d) Limited liability limited partnerships; and

e) Statutory trusts.

8) Furthermore:

a) Under amendments to the corporate statutes of several states in recent decades, it has become possible to form state-law business corporations that have a management structure and many other business organization law features that make them virtually indistinguishable from traditional general and limited partnerships.

b) In recent decades, the state statutory law governing general and limited partnerships has also undergone major change. For example:

i) Historically, neither general nor limited partnerships were treated as entities under state statutory law. However, most contemporary state general and limited partnership statutes endow partnerships with entity status.

ii) In addition, traditional state limited partnership statutory law provided that limited partners who participated in limited partnership management would lose their liability shield. However, many contemporary limited partnership statutes permit limited partners to exercise extensive management rights in their limited partnerships without forfeiting their limited liability.

c) The purpose of the Check-the-Box Regulations is to define the default federal tax classification of domestic and foreign business entities and, in the case of unincorporated business entities, to permit elections into other classifications. These rules are summarized in Part III of this newsletter. The Check-the-Box Regulations provide that the determination of the default classifications of all types of business entities must be made on the basis of specified business organization law characteristics.

Among other things, the Check-the-Box Regulations provide very clear rules for determining the federal tax classification of single- and multi-member LLCs and of the other new types of entities identified above; and in defining what types of entities must be classified for federal tax purposes as corporations and partnerships, the Check-the-Box Regulations take into account the above major changes in corporate, general partnership and limited partnership statutory law.[32]

[32] "Federal tax purposes" principally include purposes relating to federal income taxes, Social Security taxes and federal excise taxes.

II. THE IMPACT ON THE LLC BUSINESS ORGANIZATION FORM

1) The federal tax classification rules that immediately preceded the Check-the-Box Regulations were referred to by tax practitioners as the Kintner Regulations. The rules in the Kintner Regulations were complex and often difficult to apply; they did not address the federal tax classification of single-member LLCs; and to facilitate the classification of LLCs as partnerships under them, state LLC statutes contained tax-driven provisions that made little sense from a business organization law viewpoint.

2) The rules in the Check-the-Box Regulations are far clearer and easier to apply than the Kintner Regulation rules; they address the federal tax classification of single-member LLCs; and they are easy and safe to apply to all types of business entities. The adoption of the Check-the-Box Regulations made it possible to remove the above tax-driven LLC statutory provisions; and the adoption of the Check-the-Box Regulations triggered a vast nationwide increase in the formation of LLCs.

3) To illustrate the explosion of the popularity of the LLC form: In 1998, the year after the adoption of the Check-the-Box Regulations, a total of 30,701 LLCs were formed under the Delaware Limited Liability Company Act; in 2007, the total was 81,923.

III. THE KEY RULES IN THE CHECK-THE-BOX REGULATIONS

The three most important rules in the Check-the-Box Regulations are those that deal with the federal tax classification of *domestic* state-law business entities. These rules and their impact on the determination of the federal income tax regimens of business entities are summarized below and in the table in Exhibit A to this newsletter.

1) <u>The federal tax classification of business entities formed under corporate statutes; the federal income tax regimens available to these entities</u>. If a domestic business entity is formed under a state-law business organization statute under which it is identified as a corporation:

   a) Its federal tax *classification* will be that of a corporation.

   b) Its default federal income tax *regimen* will be Subchapter C.

   c) However, if it meets Subchapter S eligibility requirements and makes a valid S election, its federal income tax regimen will be Subchapter S.

2) <u>The federal tax classification of single-owner unincorporated business entities; the federal income tax regimens available to these entities</u>. If an entity is a *single*-owner "unincorporated" business entity (i.e., an entity *not* formed under a corporate statute):

   a) Its default federal tax *classification* will be that of a disregarded entity—a new classification not appearing in the IRC itself and specifically developed by the U.S. Treasury Department for use in the Check-the-Box Regulations.

   b) However, the entity may elect to be classified as an *association*. Associations are a type of business entity that is identified in IRC § 7701 as fitting within the federal tax classification of "corporation" but that is not defined in that section. In general, associations are state-law business entities that are not denominated as corporations under the relevant state business organization law, but that, for policy reasons, the U.S. Treasury Department has decided should be taxable as corporations.

c) The default federal income tax *regimen* of a business entity classified as an association is Subchapter C.

d) However, if the entity meets Subchapter S eligibility requirements and makes a valid S election, its federal income tax regimen will be Subchapter S.

3) The federal tax classification of multi-owner unincorporated business entities; the federal income tax regimens available to these entities. If an entity is a multi-owner "unincorporated" business entity:

a) Its default federal tax *classification* will be that of a partnership.

b) Its default federal income tax *regimen* will be IRC Subchapter K.

c) However, it may elect out of its default federal income tax regimen as a partnership and into classification as an association. If it makes this election:

i) Its default federal income tax regimen will be Subchapter C.

ii) However, if meets Subchapter S eligibility and election requirements, its federal income tax regimen will be Subchapter S.

IV. CONCLUSION

The Check-the-Box Regulations determine the federal tax classification of business entities formed under U.S. statutory business organization law or foreign business organization law. On the basis of these federal tax *classifications*, federal tax practitioners can determine from the terms of the IRC which federal income tax *regimens* are available to these entities. All lawyers who form New Hampshire LLCs should have at least a basic understanding of the Check-the-Box Regulations. Lawyers who handle LLC tax issues must understand them comprehensively.

EXHIBIT A

FEDERAL TAX CLASSIFICATION AND TAXATION OF BUSINESS ENTITIES —OVERVIEW

TYPE OF STATE-LAW BUSINESS ENTITY	DEFAULT FEDERAL TAX CLASSIFICATION; AVAILABLE ELECTION TO ANOTHER CLASSIFICATION	AVAILABLE FEDERAL INCOME TAX REGIMENS	EXAMPLES UNDER NEW HAMPSHIRE BUSINESS ORGANIZATION LAW
1. Single-owner or multi-owner entity identified as corporation in the statute under which it is formed	Default federal tax classification is that of corporation. May not elect any other federal tax classification.	Default federal income tax regimen is Subchapter C. May elect Subchapter S if Subchapter S eligibility and election rules are met.	Corporation formed under New Hampshire Business Corporation Act
2. Single-owner unincorporated business entity	Disregarded entity, but may elect to be classified as an association	If entity accepts default federal tax classification of disregarded entity, it will be disregarded for federal tax purposes and its tax items will be deemed to be those of its member. If it elects to be classified as an association, its default federal income tax regimen will be Subchapter C but it may elect Subchapter S if it meets the relevant requirements.	Single-member LLC formed under New Hampshire Limited Liability Company Act
3. Multi-owner unincorporated business entity	Partnership, but may elect to be classified as an association.	If entity accepts default federal tax classification of disregarded entity, it will be disregarded for federal tax purposes and its tax items will be deemed to be those of its member. If it elects to be classified as an association, its default federal income tax regimen will be Subchapter C but it may elect Subchapter S if it meets the relevant requirements.	Multi-member LLC formed under New Hampshire Limited Liability Company Act; general partnerships and limited liability partnerships formed under New Hampshire Partnership Act; limited partnerships and limited liability limited partnerships formed under New Hampshire Limited Partnership Act

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JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 61 (JULY 15, 2009)

NEW HAMPSHIRE NON-TAX CHOICE OF ENTITY MADE EASY—A FOUR-TABLE METHOD

EXECUTIVE SUMMARY. Non-tax choice of entity is the process whereby lawyers choose the best business organization type for clients starting new businesses. The choices include, for example, LLCs and corporations. For many businesses, the process is a critical one with high legal stakes. For most businesses, it can be performed competently by knowledgeable lawyers through the use of the four tables set forth in Exhibit A to this newsletter. New Hampshire accountants should have at least a general familiarity with these tables.

DISCUSSION

1) Introduction. The business organization law background of the tables in Exhibit A is complex, and I will discuss various specific aspects of this background in detail in future newsletters. However, I believe that for lawyers generally familiar with New Hampshire business organization law, these tables will be largely self-explanatory. Thus, in this newsletter, I will provide only a brief introduction to the key concepts in the tables.

2) Entities available to individuals that want to form single-owner businesses. There are three types of business entities (also known more technically as "business organization forms") available and potentially useful to New Hampshire *individuals* who want to start *single-owner* businesses. These are:
   a) Sole proprietorships;
   b) Single-member LLCs; and
   c) Single-shareholder corporations.

3) Entities available to entities that want to form single-owner businesses. There are three types of business entities available and potentially useful to New Hampshire *entities* (e.g., corporations and LLCs) that want to start *single-owner* businesses. These are:
   a) Divisions (i.e., administrative units of entities to which are assigned entity assets or operations);
   b) Single-member LLCs; and
   c) Single-shareholder corporations.

4) Entities available to groups of two or more founders that want to form multi-owner businesses. There are seven main types of business entities potentially useful to *groups of two or more New Hampshire individuals or entities* that want to start *multi-owner* businesses. These are:
   i) General partnerships that are *not* registered with the New Hampshire Secretary of State as limited liability partnerships ("LLPs");

ii) General partnerships that *are* registered with the New Hampshire Secretary of State as LLPs;

iii) Limited partnerships that are *not* registered with the New Hampshire Secretary of State as limited liability limited partnerships ("LLLPs") and whose general partners are *not* corporations or LLCs;

iv) Limited partnerships that *are* registered with the New Hampshire Secretary of State as LLLPs);

v) Limited partnerships whose general partners *are* corporations or LLCs;

vi) Multi-shareholder corporations; and

vii) Multi-member LLCs.

5) The five business organization law factors. There are five main types of business organization law factors that lawyers should consider in choosing among the various types of entities potentially useful to individuals who want to form single-owner businesses; entities that want to form single-owner businesses; and to groups of two or more individuals or entities that want to form multi-owner businesses. These factors and the questions that lawyers should ask about them are set forth below. Exhibit A, Table 1 lists these factors and briefly states the types of business founders ("founders") for whom they may be important.

i) Liability shields. In the business in question, can the founders benefit from having a liability shield? If so, which of the types of business entities available to them will provide them with the best such shield?

ii) Charging order protections. Can the founders benefit from statutory charging order protections in conducting their business? If so, which of the types of entities available to them can provide these protections?

iii) Management structure. Which of the types of management structures available to each of the various types of business entities available to the founders will provide the founders with the best management structure?

iv) Continuity of life. Which of the types of business entities available to the founders will provide the founders and their successors with the best continuity of entity life if the founders die (if they are individuals) or if they are dissolved (if they are entities)?

v) Ease of transfer of business assets. Do the founders want to be able to transfer multiple business assets of their businesses to third parties by gift, sale or otherwise upon the founders' death or dissolution or at some other time before the dissolution of their business? If so, which type of business entity available to them will best facilitate such a transfer?

6) How to use the tables to perform non-tax choice of entity analyses. In order to perform a non-tax choice of entity analysis:

a) Lawyers should first decide which of the above five business organization law features their clients need. Some clients may need none of them; some may need all. As noted, basic guidelines for this decision are set forth in Exhibit A, Table 1.

b) Lawyers should then determine from Exhibit A, Tables 2, 3 or 4 which of the business entities available to their clients will provide the greatest number of these features to the greatest degree.

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.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 62 (AUGUST 12, 2009)

THE REPEAL OF THE EXEMPTION OF NEW HAMPSHIRE RESIDENTS FROM THE INTEREST AND DIVIDENDS TAX ON LLC DISTRIBUTIONS

Part I—Introduction

EXECUTIVE SUMMARY. With the enactment of a bill of the New Hampshire Legislature designated HB 2-FN-A-LOCAL ("HB 2"), New Hampshire residents who are members of LLCs with "non-transferable shares" have become subject for the first time ever to the five-percent New Hampshire Interest and Dividends Tax on distributions from their LLCs. This newsletter briefly summarizes the content of HB 2 as applicable to New Hampshire residents and comments on the legislative policy underlying it. Forthcoming issues of this newsletter will discuss techniques for lessening the adverse impact of the bill.

DISCUSSION

For many years, RSA 77:3,I(b) provided in effect that New Hampshire residents who were members of LLCs that had "non-transferable shares" would be exempt from the Interest and Dividends Tax (the "I&D Tax") on distributions to them of LLC profits except to the extent that these distributions were of interest and dividend income of the distributing LLC on which the LLC had not paid the I&D Tax at the entity level. Under the default rules of the New Hampshire Limited Liability Company Act, multi-member LLCs automatically had non-transferable shares. Furthermore, it was relatively easy for knowledgeable New Hampshire accountants and lawyers to structure both the LLC agreements of single-member LLCs and those of multi-member LLCs that departed from these default rules to protect LLC members from the I&D Tax. The exemption constituted an important factor for New Hampshire business people in deciding whether to conduct their businesses as corporations or as LLCs.

Indeed, many New Hampshire corporations converted to LLCs with non-transferable shares in order, among other benefits, to protect their New Hampshire shareholders from the I&D Tax. I myself assisted many of these corporations in these conversions.[33]

However, as part of a massive effort to address severe revenue shortfalls in the current economic crisis, the New Hampshire Legislature in HB 2 effected a repeal of the above exemption (the "Repeal"), and the Repeal became effective on July 1, 2009 for

[33] I should note, however, that in doing so, I always warned my clients of the possibility that the exemption from the I&D Tax for New Hampshire members of LLCs with non-transferable shares could be repealed by the Legislature at any time—although I confess that at the time, I thought such a repeal unlikely.

distributions made in taxable years beginning on or after January 1, 2009. In other words, the Repeal is retroactive.

To illustrate the retroactive effect of HB 2: Under the bill as enacted, a distribution made on September 30, 2009 to New Hampshire members by an LLC with a taxable year ending on September 30 will presumably *not* be subject to the I&D Tax in the hands of these members. Anomalously, however, a distribution made on that date by an LLC with a taxable year ending December 31, 2009 *will* be subject to the tax.

In effect, HB subjects distributions from LLCs, whether or not these LLCs have non-transferable shares, to the same I&D Tax treatment as that to which corporate distributions have always been subject. As stated in New Hampshire Department of Revenue Administration Technical Information Release TIR 2009-008, dated July 16, 2009:

> Distributions from LLCs . . . will only be subject to the Interest and Dividends Tax *to the same extent that distributions to corporate shareholders are taxable as dividends*. (Emphasis added.)

HB 2 will subject to the I&D Tax New Hampshire residents receiving distributions from LLCs only to the extent that these distributions:

- Are from current or accumulated earnings and profits of the LLC;
- Are not liquidating distributions; and
- Exceed the amount of any deemed compensation deduction allowed for purposes of the New Hampshire Business Profits Tax.

On the above "deemed deduction" issue, TIR 2009-008 makes clear that the DRA will not treat LLC distributions to New Hampshire residents as subject to the Interest and Dividends Tax to the extent that these distributions function effectively as compensation to the distributees and to the extent that the distributions do not exceed DRA standards for determining the reasonableness of compensation under RSA 77-A:4,III and the regulations thereunder. The TIR states that on this and other issues, the DRA will initiate rulemaking to provide further clarification of HB 2 with respect to the I&D Tax "shortly."

Before HB 2 was enacted, I argued strenuously against it in the New Hampshire Legislature. So did many other New Hampshire lawyers, accountants and business people. Among other things, I pointed out in a letter to state Senator Sylvia Larsen that most New Hampshire LLCs are very small business entities with only one or two members and very modest capital and income, and I pointed out in the letter that for these LLCs, distributions of LLC profits do not function as investment income. Rather, they function as compensation, even though they are not booked as such, especially by unsophisticated LLC members who are not represented by CPAs. I am concerned that with the enactment of HB 2, the DRA will often treat at least a portion of these distributions as subject to the I&D Tax; and I am concerned that unsophisticated LLC members and those who cannot afford skilled tax advice may find it hard to contest this treatment.

Finally, I pointed out in my letter to Senator Larsen that HB 2 would effectively impose a double tax on the profits of New Hampshire LLCs—first at the entity level in the form of the 8.5% Business Profits Tax; and then at the distributee level at a five-percent rate.

However, in its desperation to increase state revenues, the Legislature ignored all such arguments, and today the I&D Tax is a fact of life for many thousands of New Hampshire LLC members for whom, until July 1, 2009, it was irrelevant. So much for the "New Hampshire advantage."

What are the practical implications of the Repeal for New Hampshire LLCs and for New Hampshire residents who are members of LLCs? For example, what are the implications of the Repeal:

- For New Hampshire businesses that have been using, or are planning to use, holding company/operating company structures consisting of two LLCs in order to avoid the Business Profits Tax and the I&D Tax; and
- For New Hampshire real estate LLCs that make distributions to New Hampshire members from the proceeds of refinancings of their real estate (a common practice of these LLCs)?

Similarly, in light of the Repeal, does it still make sense for New Hampshire corporations to consider converting to LLCs? And in the wake of the Repeal, are LLCs still preferable to corporations for New Hampshire business start-ups?

In forthcoming issues of this newsletter, I will address the above and other practical implications of the Repeal, and I will suggest techniques for mitigating its effect.

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.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 63 (October 30, 2009)

What Is "Reasonable Compensation" for Purposes of Avoiding the New Hampshire Business Profits Tax and the New Hampshire Interest and Dividends Tax?

Part I: The Statutory Basics: RSA 77-A:4,III(a) and (b)

EXECUTIVE SUMMARY. A major task of New Hampshire tax advisers has always been that of advising their clients who are LLC members about how to safely maximize their reasonable compensation deduction under RSA 77-A:4,III(a) and (b) and thus to minimize their LLC's exposure to the New Hampshire Business Profits Tax.

However, as discussed in the August 12, 2009 issue of this newsletter, the New Hampshire Legislature has recently amended the Interest and Dividends Tax statute, effective July 1, 2009, to subject New Hampshire residents who are members of LLCs to the I&D Tax on LLC distributions. This amendment has given even greater urgency to the above task, since the stakes now include exposure not only to the BPT but also to the I&D Tax.

In this newsletter issue, I will summarize the basic statutory rules for determining the reasonableness of the above deduction under RSA 77-A:4,III(a) and (b). In subsequent issues, I will summarize the New Hampshire Department of Revenue Administration administrative rules that complement these statutory rules, and I will suggest how these statutory and administrative rules should be applied to a number of hypothetical situations.

DISCUSSION

I. RSA 77-A:4,III(a) AND (b)—INTRODUCTION: THE "PROPORTIONALITY" AND "COMPARABILITY" PRINCIPLES

The key provisions of RSA 77-A:4,III(a) are quoted below. Since these provisions are largely self-explanatory, I will not comment on them here. However, it may be useful to readers to be aware that virtually all of them and all of the provisions of Rev 303.01 rest on two fundamental principles—namely, a "proportionality" principle and a "comparability" principle.

- The proportionality principle. Under the proportionality principle, the DRA will treat the compensation paid by an LLC to a member as unreasonable if it is disproportionate to the member's actual contribution to the profitability of the LLC for the taxable year in question. Thus, for example, assume that an LLC has one member, 10 employees and substantial business assets and that the LLC's

member devotes only a few hours a year to actual work for it. Under these assumptions, the proportionality principle will dictate that the LLC treat only a small portion of its profits as compensation to the member and that the remainder of these profits, if transferred by the LLC to the member, be treated as non-deductible distributions, not as deductible compensation.

- The comparability principle. Under the "comparability" principle under RSA 77-A:4,III, an important consideration that the DRA "*shall*" apply in determining the reasonableness of an LLC member's compensation is whether it is comparable to the compensation paid to owners by other companies similar to the LLC. (Italics added.)

II. RSA 77-A:4,III(a)—THE THREE-PART TEST, ETC.

1) The first sentence of RSA 77-A:4,III(a)—the basic three-part test. The first sentence of RSA 77-A:4,III(a) provides that in determining their taxable business profits for BPT purposes, LLCs may deduct the compensation they pay to their members only if this compensation is:[34]

   [i] "fair";

   [ii] "reasonable"; and

   [iii] paid to the members for "time and effort" actually spent by them "in the operation of the [LLC]."

2) The second sentence of RSA 77-A:4,III(a)—non-deductibility of amounts paid as compensation to members but attributable to return on LLC assets or the labor of LLC employees. The second sentence of RSA 77-A:4,III(a) provides, in effect, that an LLC may not deduct as compensation "any amounts as are fairly attributable to a return on:

   [i] business assets; or

   [ii] the labor of non-owner employees of the business organization."

3) The third sentence of RSA 77-A:4,III(a)—LLC has burden of proof. The third sentence of RSA 77-A:4,III(a) provides that "[t]he burden shall be upon the business organization filing the return to demonstrate the reasonableness of a deduction claimed under this paragraph, by a preponderance of the evidence."

4) The fourth sentence of RSA 77-A:4,III(a)—the BPT "comparability" test. The fourth sentence of RSA 77-A:4,III(a) provides that "[i]n considering the reasonableness of a deduction claimed under this paragraph, the [DRA] *shall* consider the claimed deduction in light of compensation for personal services of employees (italics added):

   a) In positions requiring similar

      i) responsibility,

      ii) devotion of time,

[34] In quoting the provisions of RSA 77-A:4,III(a) and (b), I have broken them up into subsections and added bracketed paragraph numbers to the extent useful to clarify their meaning.

iii) education, and

iv) experience;

b) In business organizations of similar

i) size,

ii) volume and

iii) complexity."

5) The fifth sentence of RSA 77-A:4,III(a)—factors that the DRA may take into account in determining whether LLC compensation is reasonable. The fifth sentence of RSA 77-A:4,III(a) provides that in determining the reasonableness of compensation paid by a business organization to its owners:

[T]he [DRA] shall take into account:

[i] the value to the business organization of the labor of its non-owner employees[;]

[ii] the use of the business assets of the business organization[;] [and]

[iii] any other factor which may reasonably assist the commissioner in making a determination as to the reasonableness of the claimed deduction.

III. RSA 77-A:4,III(b)—RENTAL INCOME; THE "MINIMUM DEDUCTION"

RSA 77-A:4,III(b) provides as set forth below.

(b) The amount of any deduction claimed under [RSA 77-A:4,III](a)

[i] shall not exceed the amount reported as earned income from the activities of the business organization as reflected on the federal income tax returns of the [LLC member] rendering such personal services;

[ii] but may also include an amount not to exceed:

[a] net rental income as compensation for operating rental property; and

[b] an amount not to exceed 15 percent of the gross selling price as commissions on the sale of business assets;

[iii] Provided, however, [that] a minimum deduction of $6,000 shall be allowed on account of [a member] who is a natural person actually devoting time and effort in the operation of the business organization.

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.

JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS

ISSUE NO. 64 (February 4, 2010)

LAW, TAX AND THE (ALMOST) INFINITE POWER OF CHECKLISTS

Dear Subscribers:

Some of you probably know about Atul Gawande. He's an American, but his parents, both of whom are physicians, migrated here from India. He, too, is a physician—a general surgeon at Brigham and Women's Hospital in Boston who, in addition to his general practice, specializes in operating on cancerous thyroid glands. He is also a professor at Harvard Medical School and a staff writer for The New Yorker Magazine. Besides all this, he's married, he has three young children, and about once a year he publishes a new book—which usually ends up quickly on the best seller list. (And apparently, Atul Gawande never sleeps!)

I mention Gawande because I've just finished reading his latest book; it's called *The Checklist Manifesto—How to Get Things Right*. It's a wonderful piece of writing. I'm a fairly slow reader, but once you've picked up the *Checklist Manifesto*, you literally can't put it down. It's 190 pages long. I'm sure I read it in fewer than three hours.

You might be wondering why I'm mentioning this book. I'll tell you why in a minute, but first let me summarize the book's main ideas.

- Modern medical science is dauntingly complex, and the differences even between two quite normal patients can also be immensely complex.
- This complexity manifests itself in surgical practice not only in the U.S. but also worldwide; and one result is that, worldwide, the incidence of surgical errors and surgical deaths is shockingly large and growing.
- Amazingly, there is readily at hand a very simple means that can greatly reduce surgical error: Make the surgeons and their teams use a "safe surgery checklist." Gawande himself helped develop such a list, and since 2007, the U.N. World Health Organization has been distributing and promoting it to surgeons worldwide. It consists of just 23 short questions—seven to ask before the surgical patient is anaesthetized; 11 before the skin incision; and five after the patient leaves the operating room. If you want to take a look at the WHO checklist, visit http://www.who.int/patientsafety/safesurgery/ss_checklist/en/index.html.
- The WHO checklist has run into strong resistance from more than a few surgeons. They say they already know and do everything in it; they say its use is a waste of valuable time in a practice already too full of paperwork; they say that no U.N.

bureaucracy is going to tell them how to run their operating room; and they say that surgery is not about checklists; it's about skill and brilliant improvisation by highly trained professionals. Gawande candidly admits that he himself has had many of the same thoughts about using the WHO checklist in his own operating room.

- However, the fact is that wherever the WHO checklist has been introduced, it has had an almost miraculous impact in reducing surgical error—indeed, a far greater impact than any costly new surgical instrument or antibiotic could have had. And its implementation is scot-free.
- One example of the power of the WHO checklist: By using it in five operations in a typical day at Brigham and Women's, Gawande and his team caught significant errors that were about to happen in no fewer than three of them. And Gawande was the primary author of the list!

What does Gawande's book mean for the accountants and lawyers who read this newsletter? I think the lesson of the book is that practice checklists are just as important for us as for doctors. Obviously, the stakes in accountancy and law aren't as high as in surgery. But our professions, too, involve complex bodies of knowledge and complex client problems. Furthermore, we, too, are tempted to think that we don't need checklists and can safely neglect their use. Yet practice checklists can be just as useful to us as to them—maybe more so.

I'll end with an example that is very personal to me. My Aspen general and Delaware books on LLC formation practice contain a checklist that I've designed to guide accountants and lawyers through the tax and legal tasks required in business entity formations. The list consists of 22 separate tasks. Whenever I've substantially finished doing the legal and tax work for a client forming a new business, I try to remember to go back over my entity formation checklist to make sure I haven't forgotten any significant task. I have to admit that in quite a few of these formations, my review of my checklist reveals that I've omitted at least one critical task—and often more than one. And I wrote the list! To look at the list, click here.

In other words, we accountants and lawyers, like surgeons, have to take a humbler view of checklists. We might not like them, but we've got to use them.

To subscribe to my monthly newsletter on Delaware LLC formation practice, click on the following link:
http://aspenpublishers.DraftingDelawareLLC.sgizmo.com

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