Larry's Tax Law

A Narrow Aspect of the Check-the-Box Regulations that Deserves Some Press - Changing an Entity's Tax Classification From That of a Partnership to That of an S Corporation

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Introduction

More than two decades ago, the Service announced its intention to consider simplifying the entity classification rules in Notice 95-14. It stated:

"The Internal Revenue Service and the Treasury Department are considering simplifying the classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis. The Service and Treasury also are considering adopting similar rules for foreign business organizations. Comments are requested regarding this and other possible approaches to simplifying the regulations."

The Service asked for public comments on simplification of entity tax classification. It scheduled a public hearing on the matter for July 20, 1995.

In May 1996, proposed entity classification regulations were issued by Treasury. About seven months later, on December 17, 1996, Treasury finalized the regulations. The regulations are found in Treasury Regulation Section 301.7701.

The regulations were clearly designed to accomplish the IRS's stated goal - simplifying entity tax classification. The regulations, commonly referred to as the "Check-the-Box" regulations, successfully brought an end to much of the long existing battle between taxpayers and the Service over entity tax classification. The regulations generally became effective on January 1, 1997. In a little over a month from now, they will be 25-years old.

The regulations, despite judicial challenge (e.g., *Littriello v. United States*, 2005-USTC ¶50,385 (WD Ky. 2005), *aff'd*, 484 F3d 372 (6th Cir. 2007), *cert. denied*, 128 S. Ct. 1290 2008)), have persevered, making the

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entity classification landscape free of many tax authority challenges and providing taxpayers with some objectivity and more importantly, much needed certainty. That said, despite the simplification brought into the world of entity tax classification by the Check-the-Box regulations, for which tax practitioners applauded the government, several new hazards were created. Whether these new hazards were intentional or unintentional is subject to debate. Unfortunately, not all of these hazards are obvious to taxpayers and their advisors. If taxpayers and their advisors are not extremely careful in this area, disastrous unintended tax consequences may exist. Accordingly, a good understanding of the regulations and the consequences of making, not making or changing an entity tax classification decision is paramount.

Last month, I presented a White Paper that I authored on the regulations at the NYU 81st Institute on Federal Taxation in New York City, and I will be presenting it again for NYU in San Diego on November 17, 2022. The paper provides exhaustive coverage of the regulations and covers numerous nuances and traps that exist for unwary taxpayers and their advisors. An issue which is often overlooked by practitioners is whether using the regulations to change entity status for income tax purposes is always a good idea. While I discuss the issue in some detail in the paper, the sub-issue of whether a taxpayer should use the regulations to change the tax status of a limited liability company ("LLC") taxed as a partnership to a corporation taxed under Subchapter S needs discussion. I explore that sub-issue below.

Changing an Entity's Tax Classification From That of a Partnership to That of an S Corporation

By default, an LLC with two or more owners will generally be taxed as a partnership. By properly making an entity classification election, however, such an entity could (assuming the entity and its owners meet the eligibility requirements) be treated for federal tax purposes as an S corporation.

If an eligible entity classified as a partnership properly elects to be classified as a corporation, the partnership is deemed for federal tax purposes as having contributed all of its assets and liabilities to a newly formed corporation in exchange for the shares of the corporation, and immediately thereafter, the partnership liquidates by distributing the shares to the partners. These deemed transactions occur the day before the election.

Practice Alert. A conversion of an entity taxed as a partnership to an entity taxed as a corporation requires the same tax analysis of any partnership liquidation and incorporation, including a review and application of Code §§ 351 and 357.

So, an LLC could convert to corporate status under the regulations. It is a fairly simple process. Whether having a state law LLC treated for federal tax purposes as an S corporation is a good idea, however, is a matter for debate. For many reasons, taking this approach may not be a good idea. Careful thought and consideration are required.

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Reasons for Changing Tax Status

Many reasons may point in the direction of changing the status of an LLC taxed as a partnership to an entity taxed as an S corporation, including the following:

Payroll Taxes

In general, all income that passes through a partnership to a partner from trade or business activities (other than to a limited partner) is self-employment income, subject to payroll taxes. For an S corporation, however, amounts properly characterized as distributions escape payroll taxes because they do not constitute self-employment income. This later conclusion assumes the shareholder employees of the S corporation receive reasonable compensation for actual services rendered.

The potential payroll tax savings under current law for S corporation shareholders may very well point in the direction of electing corporation tax classification status (with an S election) for current LLCs. Other viable options, however, may exist that are better suited for the entity and its owners. These options, after careful analysis and consideration may include forming the entity as a corporation at the outset, or converting the entity under state law conversion statutes to a corporation followed by the making of an S election.

Tax Free Reorganizations

Business entities classified as partnerships are not eligible to utilize the tax-free treatment offered entities classified as corporations under Code § 368(a). The potential to utilize the time-tested tax-free corporate reorganization provisions of the Code may, in some circumstances welcome electing corporation classification status (with an S election) for current LLCs. Again, better options may be available, including forming the entity as a corporation at the outset, or converting the entity under state law conversion statutes to a corporation followed by the making of an S election.

Formalities

In general, most state LLC statutes impose fewer formalities on the entities and their members. Most corporate statutes, on the other hand, impose several formalities on corporations and their shareholders, including the following requirements:

- Must have a board of directors.
- Must have officers (typically a president and a secretary).
- Must formally approve acts of the board of directors at a meeting that is convened following specific notice requirements, or in consent action minutes signed by the board members.
- Must formally approve acts of the shareholders at a meeting that is convened following specific notice requirements, or in consent action minutes signed by the shareholders.

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On the other hand, LLCs are generally required to follow fewer formalities. Annual meetings, meeting minutes or consent actions are not required under most state LLC statutes. Members or Managers are generally responsible for managing the business enterprise. A separate board of directors and a slate of officers are not required.

Consequently, given the potential for payroll tax savings in the S corporation tax classification, the ability to utilize the tax-free corporate reorganization provisions of the Code, and the lack of formalities that exist with state law LLC status, there appears to be an overwhelmingly strong argument that a state law LLC taxed as an S corporation is the best of both worlds. At first blush, it is difficult to debate that conclusion. After considering the some of the nuances and traps that exist for the unwary, the proper conclusion, however, is likely that an LLC taxed as a partnership should rarely, if ever, elect corporate tax classification status.

Reasons Against Changing Tax Status

There are several reasons pointing against changing the tax status of an entity taxed as a partnership to that of an entity taxed as an S corporation. These reasons include:

Confusion

Most business enterprises deal with third parties, including banks/lenders, government regulators, customers, suppliers and vendors. If may be difficult to explain to these parties (or show them) that the entity is an LLC for state law purposes and an S corporation for federal tax purposes. Many rigid organizations, such as lenders and regulatory bodies, may not readily understand and accept the fact that an LLC is filing IRS Form 1120S and yet does not have officers, directors, articles of incorporation, or bylaws, and does not conduct formal board and/or shareholder meetings, or maintain corporate minutes. The potential payroll tax savings under current law for S corporation shareholders may very well point in the direction of electing corporation classification status (with an S election) for current LLCs. Again, other viable options may exist that are better suited for the entity and its owners, including forming the entity as a corporation at the outset, or converting the entity under state law conversion statutes to a corporation followed by the making of an S election. Admittedly, since the Check-the-Box regulations have been around for almost 25 years, this obstacle is not likely as great as it was in prior years.

Capital Accounts

What happens to the capital accounts of the LLC upon electing S corporation status? I have researched the issue, but do not have a precise answer to this question.

What happens to the LLC members that have negative capital accounts upon conversion to S status for federal tax purposes? The answer to this question is likely easier to answer than the question about capital accounts. The members in this situation clearly have generated a tax liability to the extent of their capital account deficit.

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Retroactive Entity Classification Elections

An LLC taxed as a partnership can make a retroactive entity classification elected to be treated as a corporation. The election can be retroactive up to 75 days. Sounds good! Nevertheless, unforeseen consequences may be looming.

One obvious issue that needs careful consideration if a retroactive entity classification election is being considered is S corporation eligibility. It must exist on the day the retroactive election becomes effective and for each day thereafter. If not, the election will result in the entity being classified as a C corporation (as it never qualified for S status). This is likely **not** an intended result.

Other issues that need consideration if a retroactive entity classification election is being considered are not so obvious. These issues include payroll tax withholding, reporting and payment obligations.

If the LLC had been making significant payments to its members during the 75 days before the entity classification election is filed for services rendered, the stage is set for possible disaster.

During the entity's life as an LLC taxed as a partnership, the payments would likely have been characterized as guaranteed payments under Code § 707(c). Consequently, the LLC would not have withheld taxes as an employer from the payments. Likewise, the LLC would not have paid (with its payroll tax deposits for its employees) the employer portion of the payroll taxes on these payments. Rather, the members would have been subject to self-employment taxes on the payments under Code § 1402(a).

Assume an LLC elected to be classified for federal tax purposes as a corporation. The election was made retroactively 75 days prior to the filing of the IRS Form 8832. The compensatory payments made to the members during this 75-day period cannot be characterized as guaranteed payments since Code § 707(c) is inapplicable to corporations. These payments likely constitute wages paid by the corporation to an employee. **Oops!**

The corporation did not withhold and/or remit income or payroll taxes to the government for the payments made to the members during the 75-day period for services rendered. Presumably, an assessment of penalties for the late payments and interest are lurking. **Caution is advised.**

Example. ABC, LLC is formed, effective January 1, 2023, under State X's limited liability company act. ABC has multiple members. No election for an entity tax classification out of the default classification was filed. Accordingly, pursuant to Treasury Regulation § 301.7701-3(b)(1)(i), ABC is treated as a partnership for federal tax purposes. Member A of ABC performs substantial services for the company. As a consequence, the company pays him $40,000 per month (a guaranteed payment under Code § 707(c)). No employer withholding or payroll taxes are paid since A is a partner of ABC for federal income tax purposes. The payments are likely self-employment income to A under Code § 1402(a). On March 15, 2023, after A received total guaranteed payments of $100,000, ABC properly elects, effective January 1, 2023, to be classified as a corporation taxed under Subchapter S of the Code. Since the election was made within 75

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days of its intended effective date, the retroactive effective date of January 1, 2023 will be honored. Since ABC was **not** a partnership for federal income tax purposes when the payments to A were made (as a result of the retroactive entity tax classification election), the payments cannot constitute guaranteed payments under Code § 707(c). Instead, the likely correct answer is that the payments, as a result of the retroactive entity tax classification election, constitute wages, subject to employee withholding and reporting, and payroll taxes.

Unwanted Tax Consequences

As stated earlier, if an eligible entity classified as a partnership properly elects to be classified as a corporation, the partnership is deemed for federal tax purposes as having contributed all of its assets and liabilities to a newly formed corporation in exchange for the shares of the corporation, and immediately thereafter, the partnership liquidates by distributing the shares to the partners. These deemed transactions occur the day before the election. That sounds so simple in concept. It seems nothing could go wrong.

A. Code § 351

For starters, compliance with Code § 351 is paramount. The control requirement should not be taken for granted. If other shareholders are coming into the picture as part of a prearranged series of transactions, care needs to be implemented to ensure Code § 351 tax free treatment is attained.

B. Code § 357

Code § 357 cannot be forgotten. If the aggregate adjusted basis of the assets being contributed to the newly created corporation are less than the aggregate liabilities being contributed in the deemed incorporation, the entity tax classification election will end up being taxable. This is likely an unexpected and unwanted result.

C. Jeopardizing S Status

Code § 1362 imposes certain rigid requirements on S corporations, including the requirement that an S corporation may only have one class of stock. Having differences in the voting rights of shares alone will not cause an S corporation to have more than one class of stock. All shares of an S corporation, however, must have identical rights to liquidation and distribution proceeds. Here is where a potential time bomb could be lurking.

Most LLC operating agreements typically contain provisions that could violate the single class of stock requirement. These provisions may include, but are certainly not limited to, maintenance of capital accounts, regulatory allocation provisions, special allocation provisions, and non-pro rata distribution and

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liquidation provisions. In addition, most LLC operating agreements are not concerned with provisions that limit a member's ability to transfer the member's interest to a non-qualified S corporation shareholder. So, post S status transfers that could terminate an S election may be permitted. An example may include a transfer to a non-qualifying trust that was innocent in nature (i.e., a trust established for estate planning purposes).

An obvious solution may be to terminate any existing LLC operating agreement, effective immediately before the S election is effective. While that appears to be an effective solution, it may very well turn out to be ineffective.

Practice Alert. Most state LLC statutes expressly provide, to the extent not specifically overridden by written agreement, the statutory provisions shall govern. These statutory provisions may create more than one class of stock. So, it is important that a carefully and thoughtfully drafted agreement is put in place at the effective date of the entity tax classification election. Specifically, such an agreement needs to supersede and replace the old operating agreement and override any provision of the applicable state law LLC statutory scheme that could jeopardize the S election. Again, the loss of the S election does not invalidate an otherwise valid entity tax classification election. The result is that the entity is a C corporation for federal tax purposes - likely an unintended result.

D. Outstanding Profits Interests

It is not uncommon for LLCs taxed as partnerships to issue profits interests to key executives. Since partnerships cannot issue incentive stock options, the issuance of profit interests in the world of entities taxed as partnerships is likely more common today than ever before.

In accordance with Revenue Procedure 93-27, as clarified by Revenue Procedure 2001-43, the recipient of a profits interest, subject to specific exceptions, does not have a taxable event upon grant. This is another reason why the use of these types of compensatory devices are commonplace in entities taxed as partnerships.

A profits interest is generally similar to a stock appreciation right. It gives the recipient only a share of future profits and appreciation of the company. The recipient has no rights to current capital in the company. So, if the company were to be liquidated at the end of the very day on which the recipient was awarded a ten percent profits interest in the company, assuming the company did not appreciate during that one day, the recipient (despite the ten percent interest) would receive none of the liquidation proceeds. Likewise, if the company was properly valued at $5 million upon grant of the profits interest, and it was liquidated a short time later, at which time the company had appreciated by $1 million, the recipient of the profits interest would receive $100,000 (ten percent of the appreciation) rather than $600,000 (ten percent of the company's value at liquidation). Since all of the shares of the company do **not** confer identical rights to distribution and liquidation proceeds, an outstanding profits interest would invalidate the S election.

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Practice Alert. Before considering making an entity tax classification election, a review of outstanding interests in the entity is absolutely necessary.

Conclusion

All in all, after weighing the pros and the cons, making an entity tax classification election under the Check-the-Box regulations so that an LLC currently taxed as a partnership will be taxed as an S corporation is fraught with problems. Granted, such a strategy brings with it the potential for payroll tax savings (as well as net investment tax savings under Code § 1411 assuming the owner is an active participant in the business), the ability to utilize Code § 368 (tax free reorganizations), and minimization of entity formalities. Nevertheless, the strategy is accompanied by several potential problems, including confusion among regulators, customers, lenders/bankers, vendors and suppliers; disappearing capital accounts; retroactive entity tax classification unanticipated issues; unwanted tax consequences; and the potential loss of S status. Consequently, making an entity tax classification election for an LLC taxed as a partnership to become an LLC taxed as an S corporation is **not** generally recommended. At the very least, alternatives should be explored.

When forming a new eligible entity that intends to immediately elect out of its default status as a partnership or disregarded entity to corporate status for federal tax purposes, consider making the election before the owner(s) contribute any assets to the entity. Arguably, this approach avoids any adverse tax consequences resulting from the deemed entity tax classification transactions because the post-election contributions to capital occurred directly to the corporate entity (which began its existence under its elected status without beginning under the default classification status and then moving to the elected status).

The Check-the-Box regulations streamlined entity tax classification. The simplicity, however, may generate unwarranted respite. When using the regulations, caution and careful analysis of the tax consequences is required.

Posted in Federal Law, IRS, Legislation

Tagged as Check-the-Box regulations, entity classification, limited liability companies (LLCs), New York University (NYU), partnerships, S Corporations, Treasury

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