

NEW WAYS



Advantages of Limited Liability Companies

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Two common legal forms of doing business are the limited partnership and the S corporation. But both have problems. Limited partnerships require the general partner(s) to have unlimited liability for the company's debts and S corporations have significant limitations on who can be shareholders. Your alternative?

Set up your business as a limited liability company (LLC). LLCs are a great compromise between limited partnerships and S corporations as a means of achieving asset protection and tax- and estate-planning goals.

tax considerations

An LLC is a pass-through entity. Income and losses are reflected on the owners' returns as they are with a partnership.

The LLC files a return informing the IRS and LLC members of each member's share of LLC income, expenses, deductions, etc. (One-member LLCs, which are permissible in all states, are treated as "disregarded" entities. Their owners report LLC items on Schedule C of their Form 1040s.)

An LLC does not have limitations on who can be a member, in contrast to S corporations, which are limited to 75 shareholders, none of whom can be corporations or foreigners. *Other considerations...*

•**Special allocations.** Like partnerships, LLCs can allow for special

allocation of profits and losses. These items can be split disproportionately among the members. S corporations must make allocations solely on the basis of ownership. Attempts at disproportionate allocations can be viewed as a second class of stock, thus jeopardizing S corporation status.

•**Basis.** Owners of all pass-through entities—partnerships, LLCs, and S corporations—can deduct their share of losses only to the extent of their basis in the entities. But S corporation shareholders cannot increase their basis in stock through corporate borrowing. Members of LLCs, like partners, can.

Example: An LLC that owns real estate takes out a mortgage. A member owning 50% of the company can increase the basis of his LLC interest by 50% of the mortgage—even though he is not personally liable for the debt.

Note: Limited partners can increase their basis by business borrowing only if the debt is a nonrecourse loan (i.e., no personal liability).

•**Self-employment tax.** S corporation shareholders pay Social Security and Medicare taxes (FICA) only on salaries paid to them—

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they do not pay FICA on their share of corporate profits.

General partners pay Social Security and Medicare taxes (self-employment tax) on their share of partnership income, whether it's distributed to them or not. Limited partners pay self-employment tax only on guaranteed payments they receive.

Are LLC members treated as general or limited partners? The IRS has yet to provide clear guidance. Most experts think that managing members active in day-to-day operations are akin to general partners and subject to self-employment tax on their share of LLC income, while nonmanaging members are like limited partners, not subject to self-employment tax.

There's also no requirement to hold annual meetings or maintain minutes (although it's good business practice to do so). Therefore, penetrating the business structure to hold owners personally responsible for debts may be more difficult.

asset protection

As the name implies, LLCs are designed to provide personal liability

TAXPAYER WINS ON INTEREST

The Tax Court can review "interest overpayments." During a Tax Court dispute, a company said the IRS owed it interest on tax overpayments. The IRS replied that the Tax Court could not hear this claim and the company had to file in another court to make it.

Why: Tax Court jurisdiction is limited to reviewing payments of tax. And the claim for interest was not for a refund of any tax the company had actually paid—it was just an alleged general obligation of the government.

Court: To compute interest owed by a taxpayer, which it obviously can do, the Court must consider any net interest on both under- and overpayments. So overpayment interest is clearly within its jurisdiction to rule on.

protection to owners. Generally, creditors of an LLC can only look to company assets to satisfy their claims. Creditors of members can attach distributions by obtaining a "charging order." But they don't gain ownership rights, such as voting rights or the ability to dissolve the entity, so that creditors may be convinced to settle claims reasonably.

Caution: One bankruptcy court (*In re Ashley Albright, Bnkrtcy Ct.*, Case No. 01-11367) has decided that a one-member LLC can be forced to liquidate so that creditors can obtain the LLC's property when the member files for bankruptcy. Only a few states provide that the charging order is the exclusive remedy.

S corporations also afford personal liability protection. For example, an S corporation's landlord can look only to the corporation for lease payments. But asset protection for S corporation shareholders is not absolute. Creditors can attach shares and exercise ownership rights. If the shares represent a majority interest, the creditor can force a liquidation (a creditor may be able to do so with as little as 20% of the shares, depending on state law).

Limited partnerships afford personal liability protection only to limited partners...general partners are liable for the claims of the partnership's creditors. However, it may be possible to create liability protection for a general partner by using only a corporation or LLC for this purpose, with other members holding limited partnership interests.

estate planning issues

The goal of estate planning for these entities is to be able to transfer interests to family members using IRS approved discounts in valuation. This allows greater interests to be transferred at no additional tax cost.

Family limited partnerships (FLPs)—limited partnerships owned by a family

—shine here. Interests in them usually are valued at substantially less than the value of the underlying assets because of factors such as lack of marketability and minority interests.

Despite a recent Tax Court decision (*Estate of Strangi*, TC Memo 2003-145) holding that transferred interests were included in the transferor's estate because he retained control over the entity, there is still considerable opportunity for estate and gift tax savings. The decision's impact can be avoided by giving up control to obtain tax savings or selling rather than gifting interests.

S corporations, in contrast, have some limitations. While valuation discounts may apply, gifts to minors can be problematic because trusts for their benefit must meet S corporation restrictions in order for the trusts to remain eligible shareholders.

LLCs can achieve the same estate planning advantages of FLPs. Again, the question of control over the entity would need to be addressed in any estate plan where transfers are to be made.

bottom line

Since LLCs have not been around for long—they first received IRS approval in 1987—there are still unsettled questions.

Important: Look into the various forms of doing business before settling on an LLC.

Discuss your situation with a knowledgeable attorney who can help you prioritize your goals to make the best entity selection and avoid being trapped in the wrong one. **TH**

