

Dale R. Baringer
THE BARINGER LAW FIRM, L.L.C.
Baton Rouge, Louisiana 70802
Ph. (225) 383-9953
Fax: (225) 387-3198
website: www.baringerlawfirm.com
email: dale@baringerlawfirm.com

II. ADVANCED LLC ISSUES

ADVANCED TAX ISSUES FOR LLCs

Basic Entity Tax Structures

A. Partnership Tax Considerations

Under the IRC, a partnership is “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a trust or estate or a corporation,” and a partner is a member of such an entity. [IRC §7707(a)(2)]. A partner can be an individual, a trust, another partnership, a corporation, or another entity (such as an LLC).

A partnership is not a separate taxable entity under the IRC. It serves as a conduit for the passing of income, deductions, and credits to its partners; thus the name “pass-through” or “flow-through” entity. (IRC §701). Net income or loss (less certain items which are separately stated) for the business is calculated at the partnership level, and the partnership allocates it to the partners as agreed in the partnership agreement. (IRC §§ 703 & 704). The partners then are required to include their shares of the income or loss and the separately stated items on their own tax returns. The partners are taxed on their allocable shares each year, whether or not it is distributed to them. When the previously taxed amounts are actually distributed to the partners, there is no additional tax. The partnership reports partnership level calculations and each partner’s allocation to the IRS and to the partners (IRS Forms 1065 and K-1).

While income and deductions attributable to the partnership’s business operations are netted at the partnership level and the net operating income or loss allocated to the partners [IRC §703(a)], items limited or otherwise specially treated under the tax law at the partner level, as well as portfolio income, are allocated to the partners item by item. [IRC §702(a)]. These “separately stated items” include capital gains and losses, dividends, interest, rents, royalties,

Baringer
Advance Tax Issues

deductions attributable to portfolio income, charitable contributions, foreign taxes paid, and other items affecting the tax liability of the separate partners. Oil and gas partnerships must allocate depletion deductions and intangible drilling costs separately because these may be subject to limitations at the partner level. The partnership agreement may call for other items to be separately allocated to some or all of the partners. Allocated items retain their character in the hands of the partners (i.e. an allocated long term capital gain will be reported as such by the partner on his individual tax return). [IRC §702(b)].

The separately stated items and the partnership income or loss can be allocated to the partners by special agreement. Profits may be allocated in one proportion but losses allocated differently. The IRS generally allows any allocation the partners use on their own books of account. However, the allocation must have “substantial economic effect” (and may not be merely for the purpose of reducing taxes). [Treas. Reg. §1.701(b)]. If the partnership agreement does not specify the allocation, or the IRS disallows it, it must be made according to the partners’ ownership interests in the partnership [IRC §704(b)].

In addition to being entitled to a share of the partnership’s profits and losses, partners may also be given guaranteed payments for their capital or services. [IRC §707]. These are payments of fixed amounts that do not depend on the profits of the business. §707 provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, subject to certain exceptions, the transaction is considered as occurring between the partnership and one who is not a partner. The value of fringe benefits given to partners in return for their services, such as health insurance, is also considered a guaranteed payment. The partnership deducts guaranteed payments as ordinary business expenses, and the partners include them in income as ordinary (self-employment) income.

A partner’s basis in his or her partnership interest, for calculating gain or loss when the interest is sold or cashed in, consists of his or her original contribution to the partnership, increased by each year’s distributive share of the partnership’s total income or decreased by each year’s distributive share of total loss. It is also decreased by any actual distributions (cash withdrawals) and increased by any additional capital contributions. [IRC §705]. A partner’s basis also includes a share of the debts of the partnership. Partners may deduct allocated losses against other income only up to the extent of their basis in their partnership interest; since basis can never be less than zero, a partner’s basis effectively limits the deductibility of losses.

Contributions to partnerships are generally treated as tax-free exchanges. Neither the partner nor the partnership recognizes gain or loss on the contribution. [IRC §721]. The partner’s basis in his partnership interest is increased by the amount of any money and the basis of any property contributed to the partnership. [IRC §722]. The partnership takes a carryover basis in the contributed property. [IRC §723]. An exception to this rule applies when a partner acquires a partnership interest in exchange for services. If the acquired interest is in partnership capital, the service partner realizes income in the amount of the value of the capital interest

transferred, and the partnership recognizes gain or loss to the extent the transferred capital has a value different from its basis to the partnership. If the acquired interest is only in future profits of the partnership, the service partner generally does not recognize income. Receipt of a partnership interest for services may be tax free if the partnership interest is subject to a substantial risk of forfeiture or is non-transferrable under IRC §83. The receipt of an interest in partnership profits-only may be non-taxable to the service provider under certain circumstances where the income interest is not readily susceptible to valuation. See *Campbell v. Commissioner*, TC Memo 1990-162, rev'd 943 F2d 815 (8th Cir. 1991); Treas. Reg. § 1.721-1(b)(1); Rev. Proc. 93-27, 1993-24 IRB 63; Rev. Proc. 2001-43, 2001-34 IRB. However, see Prop. Reg. §1.721-1(b)(1), the preamble thereto, and IRS Notice 2005-24 IRB. Under these proposed regulations, to the extent a partnership interest is transferred to a partner in connection with the performance of services rendered to the partnership, it would be treated as a guaranteed payment for services under IRC §707(c). IRC §721 generally would not apply and the transaction would be one to which IRC §83 and its regulations apply. Under Proposed Reg. §1.83-3(1), a partnership and all of its partners may elect a safe harbor under which the fair market value of an interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest. This would allow for the transfer of a profits-only partnership interest for services rendered to the partnership to be tax free to the service provider to the extent liquidation value might result in no value for future profits of the enterprise.

Pending Legislation on “Carried Interests”

Legislation is currently pending in Congress in the House Ways & Means Committee that would amend IRC §83(c) by redesignating paragraph (4) as paragraph (5) and inserting a new paragraph (4) which would read as follows:

(4) PARTNERSHIP INTERESTS. – Except as provided by the Secretary, in the case of any transfer of an interest in a partnership in connection with the provision of services to (or for the benefit of) such partnership --

(A) the fair market value of such interest shall be treated for purposes of this section as being equal to the amount of the distribution which the partner would receive if the partnership sold (at the time of the transfer) all of its assets at fair market value and distributed the proceeds of such sale (reduced by the liabilities of the partnership) to its partners in liquidation of the partnership, and

(B) the person receiving such interest shall be treated as having made the election under subsection (b)(1) unless

Baringer
Advance Tax Issues

such person makes an election under this paragraph to have such subsection not apply.

The legislation would also create a new IRC §710 that would apply to acquisitions of any “investment services partnership interest” and require that any gain or loss on the disposition of an investment services partnership interest would, generally, be treated as ordinary income and recognized. For individual partners, generally, 75% of such gain or loss would be ordinary unless the partnership interest was held more than 5 years, in which case the applicable percentage would be 50%. The amount recognized as ordinary income would be subject to self-employment taxes for individuals.

B. C Corporation Tax Considerations

The term “corporation” is defined by IRC §701(a)(3) to include associations and joint stock companies. Therefore, the corporate income tax is imposed on some enterprises that do not constitute corporations under state law.

With some exceptions, the taxable income of a corporation is computed in much the same fashion as an individual’s taxable income. As the IRC treats corporations as independent tax-paying entities, corporate income is taxed to a C corporation as it is received or accrued, but the shareholders are taxed only when, as, and if the corporation distributes earnings to them or they sell their stock. When individual income tax rates are higher than the corporate rate, it could be advantageous for the owner to operate in the C corporation form, grow the corporation and sell his stock at capital gains. The current tax rates applicable to corporations and individuals were discussed in the first outline. The graduated tax brackets for corporations must be divided among commonly controlled corporations which prevents individual taxpayers from creating several corporations to take advantage of several graduated tax brackets for the different corporations.

The IRS is equipped with a number of tools to attack attempts to insulate undistributed income from taxation to the shareholders. IRC §482 allows the IRS to reallocate gross income, deductions, credits, and other tax allowances between two or more businesses under common control if necessary to clearly reflect their respective incomes. IRC §531 imposes an accumulated earnings tax on the undistributed income of a corporation formed or availed of for the purpose of avoiding the income tax by accumulating instead of distributing its earnings and profits. As was mentioned earlier in these materials, the Tax Relief Act of 2003 reduced the accumulated earnings tax to 15% in order to keep it in line with the new 15% maximum tax on dividend distributions. IRC §541 imposes the personal holding company tax on the undistributed income of a “personal holding company,” which generally includes corporations whose principal function is the collection of dividends, interest and other passive income, as well as so-called incorporated talents and incorporated country estates and yachts. The personal holding company tax was, likewise, reduced to a maximum rate of 15% by the Tax Relief Act of 2003.

Baringer
Advance Tax Issues

A C corporation can deduct its own losses, subject to certain carryback and carryforward rules applicable to net operating losses and capital losses. IRC §172(a). The shareholders of the C corporation cannot avail themselves of the corporation's unused corporate losses, although they may deduct losses when their stock becomes worthless, generally as a capital loss unless the stock is IRC §1244 stock.¹

Relative to the formation of corporations, IRC §1001(c) provides that taxpayers must recognize all gain or loss realized on the sale or exchange of property, "except as otherwise provided." IRC §351 provides the general rule that no gain or loss is recognized if property is transferred to a controlled corporation "solely" in exchange for its stock. If the transferor receives not only stock but also money or other property ("boot") in the exchange, §351(b) provides that gain (but not loss) is recognized to the extent of the fair market value of the boot, but not in excess of the amount of the transferor's realized gain under §1001. Debt assumed by the corporation in connection with the transaction may be treated as money received by the transferor if it appears the principal purpose of the transaction was to avoid federal income tax on the exchange or there is no bona fide business purpose. Additionally, if the sum of the liabilities assumed with respect to the transferred property exceeds the total of the adjusted basis of the property transferred, then the excess is considered gain from the sale or exchange of the property.

§351 applies only if the transferor or transferors of property are "in control" of the corporation, as defined in §368(c), immediately after the exchange. The transferor is deemed to be in control of the corporation for purposes of §351 if the transferor(s) own stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote, and at least 80% of the total number of shares of all other classes of stock of the corporation. The control test applies to transferors as a group if each transferor transfers property, receives only stock in the exchange (or stock plus boot), and own stock immediately after the exchange – all as part of an integrated transaction between the corporation and the other transferors of property.

§351 does not apply to transfers of property to an investment company. There are numerous additional exceptions and special rules which may apply to the §351 exchange transaction.

The basis of the stock received in a §351 exchange transaction is the same as the basis of the property transferred decreased by the fair market value of any other property (except money)

¹ Section 1244 Stock is stock in a domestic corporation which qualifies as a small business corporation, is issued by the corporation for money or other property (other than stock or securities), and the corporation derives more than 50% of its income from sources other than royalties, rents, dividends, interest, annuities and sales or exchanges of securities. A small business corporation is one where the aggregate amount of money and other property received by the corporation for stock does not exceed \$1,000,000. Losses when Section 1244 Stock becomes worthless are deductible as ordinary losses.

received by the taxpayer on the exchange; and increased by the amount which was treated as a dividend and the amount of gain to the taxpayer which was recognized on such exchange. IRC §358. Property acquired by a corporation in a §351 transaction or as paid in capital or as a contribution to capital is the same as the basis it had in the hands of the transferor, increased by the amount of gain recognized to the transferor on the transfer. Under IRC §1032, the corporation recognizes no gain or loss on the receipt of money or property in exchange for stock of the corporation. Under IRC §118(a), gross income of a corporation does not include any contribution to the capital of the corporation.

Under the law prior to the 2003 Tax Relief Act, an individual taxpayer paid tax at ordinary income tax rates on dividends (other than dividends treated as returns of capital). Beginning with tax years after December 31, 2002, a taxpayer's "qualified dividend income" is treated as net capital gain for tax rate purposes and thus subject to tax at the same rates that apply to net capital gain for both regular tax and alternative minimum tax purposes.² Under the new law, this results in ordinary tax rates applicable to qualified dividend income of either 5% or 15%. Qualified dividend income is income from domestic corporations and certain qualified foreign corporations.

Under IRC §301 and 316, distributions of property by a corporation to a shareholder with respect to its stock are treated as a "dividend" only to the extent it is a distribution out of its accumulated earnings and profits after February 13, 1913, or out of its earnings and profits of the current taxable year, computed as of the end of the year. Distributions by corporations are deemed to be distributed first out of the earnings and profits of the corporation, and from the most recently accumulated earnings and profits first. The amount distributed is the amount of money received, plus the fair market value of other property received. IRC §301(b).

That portion of any distribution which is not a dividend is applied against and reduces the basis of the stockholders' stock in the corporation. IRC §301(c). To the extent such a distribution exceeds a stockholder's basis in his stock, it is treated as gain from the sale or exchange of property. The stockholder takes a basis in any property received as a distribution on his stock equal to the fair market value of the property. IRC §301(d).

A corporation recognizes gain upon the distribution of property to a stockholder in a distribution with respect to the stock in the corporation if the fair market value of the property exceeds the adjusted basis of the property in the hands of the distributing corporation. IRC §311(a).

² The new law adds qualified dividend income to net capital gain only for purposes of IRC section 1(h), it does not change the basic definition of "net capital gain" set forth in section 1221(11) - which is excess of net long-term capital gain (excess of long-term gain over long-term losses) for the tax year over net short-term loss (excess of short-term losses over short-term gains) for the year. Thus dividend income is treated separately from the general net capital gains calculations, qualified dividend income cannot be offset or reduced by other types of capital losses, and is taxed in full at the appropriate capital gains rates.

Gross income includes “gains derived from dealings in property.” IRC §61(a)(3). Gain from the sale or other disposition of property is determined by the excess of the amount realized therefrom over the adjusted basis provided in IRC §1011 for determining gain. IRC §1001. “Amount realized” is the sum of money plus the fair market value of property received. While a disposition of property for cash and most exchanges for other property are realization events, in certain narrow circumstances a disposition of property by exchange for other property not differing in kind or extent can avoid treatment as a gain recognition event. IRC §1031. Under IRC §1031, no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of a like kind. §1031, however, does not apply to exchanges of stocks, bonds or notes.

The corporate reorganization provisions of the IRC provide rules pursuant to which exchanges of stock and securities in certain corporate reorganization transactions may occur tax free. A “reorganization” is defined for tax purposes by §368(a)(1) to include mergers, consolidations, recapitalizations, acquisitions by one corporation of the stock or assets of another corporation, divisions, and changes in form or place of organization. If the readjustment qualifies as a reorganization, the corporation recognizes neither gain or loss on any transfer of its property for stock or securities in another corporation that is a party to the reorganization, and the shareholders and creditors may exchange their stock or securities for new stock or securities without recognizing gain or loss. Moreover, the tax attributes (loss carryovers, earnings and profits, accounting methods, etc.) of a corporation whose assets are acquired by another corporation in the reorganization are ordinarily inherited by the acquiring corporation. The theory of the reorganization provisions is that gain or loss should not be recognized on changes of form when the taxpayer’s investment remains in corporate solution or when a “a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets.”³

§368(a)(1) generally defines the term “reorganization” as:

1. A statutory merger or consolidation (a “Type A Reorganization”);
2. The acquisition by one corporation, solely in exchange for all or part of its voting stock (or voting stock of a parent corporation), of the stock of another corporation if the first corporation has “control” of the second corporation immediately after the acquisition (a “Type B Reorganization”);
3. The acquisition by one corporation, in exchange for all or part of its voting stock (or the voting stock of a parent corporation), of substantially all the properties of another corporation (a “Type C Reorganization”). The

³ Bitker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, 7th Edition, 2002, Warren, Gorham & Lamont, citing Bazley v. CIR, 331 U.S. 737, reh’g denied, 332 U.S. 752 (1947).

consideration given by the acquiring corporation must be solely voting stock, except that liabilities of the acquired corporation may be assumed, property may be taken subject to liabilities; and a limited amount of money or other consideration may be paid;

4. A transfer by a corporation of all or part of its assets to another corporation if, immediately after the transfer, the transferor, its shareholders (including its former shareholders), or both in combination, are in control of the transferee corporation are distributed under the plan in a transaction that qualifies under §354, 355, or 356 (a “Type D Reorganization”);
5. A recapitalization (a “Type E Reorganization”);
6. A mere change of identity, form, or place of organization of one corporation, however effected (a “Type F Reorganization”); or
7. Certain insolvency reorganizations (a “Type G Reorganization”).

Control, for purposes of these rules means ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of all other classes of stock of the corporation. The tax free reorganization rules include numerous complex special rules, regulations and court decisions. For purposes of this program, it is important only to know that these rules allow stockholders to exchange stock on one corporation for stock in another corporation in the context of a corporate reorganization on a tax free basis. Thus, a publicly held corporation might acquire a small privately held corporation in a transaction in which the stockholders in the acquired corporation exchange their non-marketable stock in the privately held corporation for publicly traded stock in the publicly held corporation.

Thus, the basic tax structure applicable to C corporations involves what is commonly referred to as a two level taxation system under which income from the operation of the corporation’s business is generally taxed twice, once at the corporate level and again at the individual level, before the money reaches the pockets of the stockholders. Prior to the Tax Reform Act of 1986, the tax laws allowed for the stockholders of a C corporation to avoid this double tax in the context of a sale of all of the assets of the corporation in connection with the liquidation of the corporation. This was the result under former IRC §§ 311 & 337, and the U.S. Supreme Court decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). Under the former §311 a corporation was required to recognize gain on the distribution of property to its stockholders only for certain distributions of last-in, first-out property and of other appreciated property if subject to a liability in excess of its basis. The Tax Reform Act of 1986 effectively repealed both the nonrecognition rule of §311(a)(2) for nonliquidating distributions of appreciated property, and the specialized non-recognition rules of §§336 and 337 for liquidating distributions. These statutory amendments changed the lay of the land in the context of C corporation exit strategies and gave life to the movement that resulted in the adoption of limited liability statutes throughout the United States.

C. S Corporation Tax Considerations

An S corporation is a closely held corporation (or association treated as a corporation for tax purposes) that elects to be treated as a pass-through entity like a partnership. (S corporations are named for “Subchapter S” of the IRC, §§1361-1379, which governs them. Ordinary corporations are called “C corporations,” after Subchapter C of the IRC). S corporation status enables the business’s owners to retain the non-tax advantages of limited liability and other corporate attributes without the tax disadvantages of double taxation of profits and limited deductibility of losses. S corporations have been increasingly popular as a form of organization for many years, especially after the tax rate increases in 1993 (although their popularity may be diminished by the growing use of LLCs).

Qualification for S corporation status is limited by several restrictions on availability of the election. Only domestic corporations with only a single class of stock and no more than 100 stockholders may elect S status. [IRC §1361]. Husbands and wives and their estates are counted as one shareholder for this purpose. Prior to January 1, 1997 the limit on the number of shareholders was 35. In 1997 it was increased to 75. The 2004 Jobs Act liberalized the rules even further. It increases the number of shareholders an S corporation may have to 100. In addition, the 2004 Jobs Act provides that a family may elect for all family members to be treated as one shareholder. This applies regardless of whether the family member holds the stock directly or is treated as a shareholder by reason of being a beneficiary of an electing small business trust or a qualified subchapter S trust. Family members include the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestors. An individual is not considered a common ancestor if, as of the later of the effective date of this rule or the time the S corporation election is made, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this limitation) be family members. For this purpose, a spouse (or former spouse) is treated as being of the same generation as the individual to which such spouse is (or was) married. The election for all family members to be treated as one shareholder may be made by any family member and remains in effect until terminated as provided by the IRS in regulations to be promulgated. IRS has authority to waive an inadvertently invalid election for all family members to be treated as one shareholder. IRS was also given additional authority to waive inadvertently invalid QSub elections or terminations of such elections. In order to receive relief, the QSub and its shareholder (the S corporation parent) must: within a reasonable period after discovering the circumstances causing the invalidity take steps so that the corporation qualifies as a QSub and agree to IRS prescribed adjustments consistent with the treatment of the corporation as a Qsub during the relevant period.

The S corporation cannot have any shareholders who are not individuals, estates, certain types of trusts, or tax-exempt pension funds or charitable organizations. [IRC §1361(b)(1)]. S corporation stockholders must all be U.S. citizens or residents. S corporations cannot be banks

Baringer
Advance Tax Issues

using the reserve method of accounting, insurance companies, or corporations eligible for the possessions tax credit. [IRC §1361(b)(2)]. An S corporation can own a C corporation subsidiary but cannot file a consolidated tax return with it; but an S corporation can file a consolidated return of sorts with a 100% owned S corporation subsidiary (a “qualified Subchapter S subsidiary”). [IRC §1361(b)(3)].

A corporation makes the election to be treated as an S corporation, but each shareholder must consent, in writing, to the election. In consenting to the election, the shareholders agree to report and pay tax on their shares of the corporation’s income. The election can be revoked with the consent of shareholders holding more than 50% of the outstanding shares of stock. If an election is revoked, the corporation cannot elect S status again for 5 years without IRS consent. [IRC §1362].

S corporations, like partnerships, calculate operating income or loss at the corporate level and pass the net amounts through to the shareholders. [IRC §1363]. They also pass through separately those items that may have special tax attributes at the shareholder level, including portfolio income, capital gains and losses, items involved in passive loss or alternative minimum tax computations, just as partnerships do. The allocated amounts retain their character in the hands of the shareholders, and the shareholders report the amounts and pay any tax on their own returns. [IRC §1366].

S corporations cannot make special allocations of profits and losses or individual items of profit or loss because there can only be one class of stock. All allocations must be proportionate to the ownership of stock. S corporation stockholders are not subject to self-employment taxes on amounts passed through to them. This is a feature which currently tends to be a focal point in the choice of entity process for many taxpayers.

Distributions to shareholders made from accumulated earnings that have already been taxed to the shareholders are not taxed again. Similar to partners, shareholders who are also employees of the corporation may receive guaranteed salaries and fringe benefits. These are deductible by the corporation and taxable to the shareholder (fringe benefits only if the shareholder owns 2% or more of the stock). The S corporation pays employment taxes and withholds income and FICA taxes on shareholder-employee wages.

The basis of a shareholder’s stock is increased by positive amounts allocated to the shareholder and decreased by actual distributions and allocated losses and deductions. [IRC §1367]. Losses are deductible only to the extent of basis; but unlike partnerships, debt of the corporation does not increase a shareholder’s basis unless it is loaned to the corporation by the shareholder.

Special rules apply to corporations that were once C corporations when they elect to be taxed as S corporations. Earnings and profits accumulated while in a C corporation status must

be separately accounted for under rules that prevent their receiving a tax advantage from the conversion. If a corporation has such earnings and profits, and for three consecutive years more than 25% of its gross receipts consist of passive investment income, its election as an S corporation automatically terminates. Distributions from such earnings and profits may be taxable as dividends to the shareholders. Some attributes carried over from the C corporation status may trigger tax at the corporate level.

As pass-through entities, S corporations are generally not subject to the corporation income tax. However, an S corporation that was once a C corporation (or that bought out a C corporation) may be taxable on some carryovers from the C corporation. If the corporation disposes of an appreciated asset within 10 years of converting, any gain attributable to appreciation in the C corporation period is taxed at the highest rate applicable to corporations. [IRC §1374]. Any losses and credits carried over from the C corporation may be used to offset this tax. These are generally referred to as the rules on built-in gains and losses of S corporations. Taxes may also be imposed to recapture previous benefits from the use of the investment credits or the last-in-first-out inventory method by the C corporation. And if more than 25% of a converted corporation's gross receipts consist of "passive investment income" (dividends, interest, rents, royalties, and capital gains), net income attributable to the excess over 25% of gross receipts is taxed at the highest corporate tax rate.

D. Examination of the Check-the-Box Regulation

Generally, for LLCs formed after January 1, 1997, unless the LLC elects to be taxed as a corporation, it will be treated as a partnership for tax purposes governed by subchapter K of the IRC. LLCs formed prior to January 1, 1997 are subject to a different set of rules. Revenue Ruling 88-76, 1988-2 C.B. 360 held that an LLC formed under Wyoming's LLC law would be treated as a partnership for federal income tax purposes. A similar conclusion was reached by IRS in PLR 8937010 for an LLC formed under Florida law. Subsequently, IRS issued a number of favorable rulings on LLC's formed under a number of different state laws, including Louisiana. See PLR 94-04-021 (November 1, 1993) (Louisiana LLC). Note that in Rev. Rul. 94-5, 1994-2, IRB 21, the Service warned that because of the flexibility afforded by the Louisiana LLC statute, a Louisiana LLC could be classified as a partnership or as an association taxable as a corporation depending upon the provisions included in the organizational agreements. Prior to January 1, 1997, whether an LLC was taxed as a partnership or as a corporation depended upon whether the LLC was designed in a way that it complied with the myriad these and other revenue rulings and private letter rulings, where the IRS had ruled that LLC's formed under the laws of many of the states qualified for taxation as partnerships. Qualification for partnership taxation was dependent upon application of former treasury regulations known as the "Kintner Regulations". Former Treas. Reg. Section 301.7701-2.

The Kintner regulations identified four corporate characteristics which distinguished associations taxable as a corporation from partnerships. Those corporate characteristics were:

Baringer
Advance Tax Issues

- a. Continuity of life;
- b. Centralized management;
- c. Limited liability; and
- d. Free transferability of interests.⁴

If more than two of these corporate characteristics were found to exist, the LLC would be taxed as a corporation. Because the LLC statute allows for flexibility in designing the LLC, one had to be extremely wary of the possibility that customized designs might run the risk of losing the partnership taxation treatment. For instance, the IRS in Rev. Rul. 88-76 found that the Wyoming LLC lacked free transferability of interests. An organization possessed the corporate characteristic of free transferability if a member was able to substitute another person for themselves "without the consent of other members." Rev. Rul. 88-76. That ruling held that the LLC lacked the corporate characteristic of free transferability because the consent of all members was required in order for an assignee of an interest to become a substitute member of the LLC.

Therefore, if the drafter decided to provide in the organizational agreement that no consent was required for an assignee to become a member, the law allowed that to be done. However, in doing so, the organization would then have the additional corporate characteristic of free transferability of interests, and therefore could end up being treated as a corporation for federal tax purposes. Free transferability of interests could be traded off for centralized management by reserving to the individual members management authority under §§1316 & 1317 and perhaps save the partnership tax treatment. Prior to the adoption of the §7701 Check the Box regulations this area was a malpractice case looking for a place to happen. If the client had come to you and decided to go with the LLC form of entity because of its partnership tax treatment, he would be talking to a malpractice attorney if that turned out not to be the case.

On January 1, 1997, the so-called "Check the Box" regulations [26 CFR 301.7701-2(b)(1)] became effective which dramatically simplified the determination of whether the LLC and other unincorporated undertakings are to be taxed as corporations or as partnerships. Essentially, under these regulations the entity may simply elect to be taxed as either a corporation or a partnership without regard to the corporate characteristics. Thus an LLC is treated similar to a corporation for liability purposes but as a partnership for tax purposes under federal law. Under these regulations, the LLC is taxed as a partnership unless it elects to be treated as a corporation for tax purposes.

Perhaps one of the most important developments brought about by the Check the Box regulations was the treatment of single member LLC's. The regulations indicate that, for federal

⁴ ¹ See Former Treas. Reg. Section 301.7701-2(a)(3).

tax purposes, an LLC which has a single owner and does not elect to be treated as a corporation is, for federal tax purposes, disregarded as an entity separate from its owner.

Under the Louisiana statute, prior to July 8, 1997, it took two or more persons to form an LLC. §1304. There were some state statutes which allowed for single member LLC's at the time their LLC statutes were enacted. In response to the adoption of the so-called "Check-The-Box" regulations which became effective on January 1, 1997, the Louisiana legislature amended the provisions of §§ 1301(10) & 1304 to allow for single member LLCs under the Louisiana statute.

The Check-The-Box regulations set forth a system of classifying entities for federal tax purposes, which allow the elective classification of unincorporated business entities, including organizations that have only one owner. Reg. §301.7701-1; §301.7701-2; §301.7701-3.

Under the regulations, a business entity with two or more members may be classified for federal tax purposes as either a corporation or a partnership. A business entity with only one member may be classified as a corporation or its entity status may be disregarded. In the latter case, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner. Reg. §301.7701-2(a). *See* Treas. Reg. § 301.7701-3(b). An LLC may be a disregarded entity when it has a single member or when it has more than one member if only one member has 100 percent of the economic interest, 100 percent share of the profits and losses, and a 100 percent share of whatever would be distributed in liquidation. *See* PLR 200201024 (Oct. 5, 2001).

The regulations provide that a partnership is a business entity that is not a corporation under the regulations and has at least two members. [The regulations recognize the right of an otherwise qualifying partnership to elect not to be treated as a partnership under the rules of IRC §761 and Reg. §1.761-2.].

The regulations in §301.7701-2(b) require that the following entities are required to be classified as corporations:

- A business entity organized under a federal or state law, or under a law 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. Reg. §301.7701-2(b)(1).
- A business entity organized under a state law, if the law describes or refers to the entity as a joint-stock company or a joint stock association. These entities typically have a fixed capital stock divided into shares represented by certificates transferable only upon the books of the company, manage their affairs by a board of directors and executive officers, and conduct their business in the general form and mode of procedure of a corporation. Reg. §301.7701-2(b)(3).

- An insurance company. Reg. §301.7701-2(b)(4).
- A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended. Reg. §301.7701-2(b)(5).
- A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government. Reg. §301.7701-2(b)(7).
- Certain foreign business entities. Reg. §301.7701-2(b)(8).
- Under an amendment to the Check-The-Box regulations that became effective on May 1, 2006, if a business entity created or organized under the laws of more than one jurisdiction would be treated as a corporation with reference to one or more of the jurisdictions in which it is created or organized, then it is considered a corporation for federal tax purposes. Such an entity may elect its classification under Reg. §301.7701-3, subject to the limitations of those provisions, only if it is created or organized in each jurisdiction in a manner that meets the definition of an eligible entity in Reg. §301.7701-3(a), which determination is made independently of the determination of whether the entity is domestic or foreign. §301.7701-2(e)(3); §301.7701-2(b)(9).

Example: X is an entity with a single owner organized under the laws of country A as an entity that is specifically mentioned in Reg. §301.7701-2(b)(8)(i). Under Reg. §301.7701-2, such an entity generally is a corporation for federal tax purposes and is unable to elect its classification. Several years after its formation, X files a certificate of domestication in state B as an LLC. Under the laws of state B, X is considered to be created or organized in state B as an LLC upon the filing of the certificate of domestication and is therefore subject to the laws of state B. Under Reg. §301.7701-2 and Reg. §301.7701-3, an LLC with a single owner organized only in state B is disregarded as an entity separate from its owner for federal tax purposes (absent an election to be treated as an association). Neither country A nor state B law requires X to terminate its charter in country A as a result of the domestication, and in fact X does not terminate its charter in country A. Consequently, X is now organized in more than one jurisdiction.

X remains organized under the laws of country A as an entity that is specifically mentioned in Reg. §301.7701-2(b)(8)(i), and as such, it is an entity that generally is treated as a corporation under the rules of Reg. §301.7701-2. Therefore, X is a corporation for federal tax purposes because the regs would treat X as a corporation with reference to one of the jurisdictions in which it is created or organized. Because X is organized in Country A in a manner that does not meet the definition of an eligible entity in Reg. §301.7701-3(a) it is unable to elect its classification. Reg. §7701-2(b)(9)(ii).

Rev. Rul. 2004-77, 2004-31 I.R.B. 119, held that an eligible entity with two members, one of which is disregarded for Federal tax purposes, cannot be classified as a partnership, and thus is either disregarded itself or taxable as a corporation. To illustrate, X, a domestic corporation, is the sole owner of L, a domestic LLC that is disregarded for Federal tax purposes. L and X are the only members under local law of P, a state law limited partnership or LLC. L and P do not elect to be treated as associations. Under this ruling, X is treated as owning all of the interests in P because L is a disregarded entity. Thus, P has only one owner for Federal tax purposes. Because P did not “check-the-box”, P is also a disregarded entity.

E. Compensation Planning and Use of Guaranteed Payments

a. The Disregarded Entity and Employment Taxes

In 1999, the IRS issued Notice 99-6,⁵ to clarify the IRS position on reporting and payment of employment taxes by disregarded entities such as single-member LLCs and qualified subchapter S corporation subsidiaries⁶. Under this Notice, single member disregarded LLCs were allowed to report and pay employment taxes in one of two ways:

- (1) The calculation, reporting, and payment of all employment tax obligations with respect to employees of a disregarded entity could be done under the owner’s name and taxpayer ID number as if the employees of the disregarded entity were employed directly by the owner; or
- (2) The calculation, reporting, and payment of all employment tax obligations could be performed by each state law entity with respect to its employees under its own name and taxpayer identification number.

⁵ Notice 99-6, 1999-3 IRB 12.

⁶ IRC § 1361(b)(3).

Because the single member LLC that has not elected to be taxed as a corporation is disregarded for all tax purposes, the owner retained ultimate responsibility for the employment tax obligations incurred with respect to employees of the disregarded entity. As the taxpayer liable for federal income taxes arising from the LLC's operations, the owner is liable and the owner's property is subject to (i) lien for the payment of taxes [IRC § 6321], (ii) levy upon the owner's property or rights to property [IRC §6331(a)], or (iii) suit to foreclose the federal tax lien on the owner's property [IRC § 7403(a)].

The IRS took the position in Notice 99-6 that regardless of the choice made, the owner of a disregarded single-member LLC was the employer for purposes of employment tax liability.⁷ The Notice stated, "the Service will not proceed against the owner for employment tax obligations relating to employees of a disregarded entity if those obligations are fulfilled by the disregarded entity using its own name and taxpayer identification number, even if there are differences in the timing or amount of payments or deposits as calculated under the second method." For state law purposes, there could be a question of whether the LLC is making a distribution to the owner for state law purposes when the LLC pays the employment tax, since would be discharging the obligation of the owner under federal tax law. The better reasoning would seem to have been that the owner is in a position of guaranteeing the employment tax liability of the LLC, but bankruptcy courts dealing with the issue of income taxes in an S Corporation have generally taken the position that where the federal tax law imposes no tax on the S Corporation, it is not allowed to make distributions (in priority to pre-petition creditors) to the stockholders to allow them to pay the income taxes attributable to the income of the S Corporation.

The IRS can collect taxes from other persons responsible for the payment of the taxes. *See* IRC §3505(a). Under that provision, if a lender, surety, or other person, who is not an employer, directly pays the wages of the employees of a taxpayer/employer, the lender, surety, or other person is liable to the United States in an amount equal to the amount required to be withheld from such wages by the employer. An "other person" means any person who directly pays the wages of the employees of another person. It does not include a person acting only as agent of the employer.⁸ The IRS has held that a disregarded single member LLC is not an "other person" for purposes of IRC § 3505(a). The IRS has also considered whether a disregarded entity, which had filed a chapter 11, Bankruptcy was an "other person" required to collect and pay over taxes, the principal responsibility for which resided with the owner. The Chief Counsel, relying on Notice 99-6 held that the disregarded entity was not an "other person" so that the taxes were not a liability of the bankruptcy estate.

⁷ Notice 99-6, 1999-3 I.R.B. 12; See also CCM 200235023 (June 28, 2002) and 200338 012 (September 19, 2003).

⁸ Treas. Reg § 31.3505-1(c) (1) .

Two internal IRS Legal Memoranda addressed the issues relative to the liability of the member for the obligations of the disregarded single-member LLC and the ability of a payroll tax creditor of a member to reach the assets of the single-member LLC. In ILM 199922053, the Chief Counsel confirmed that as a general rule, members of disregarded LLCs are personally liable for employment taxes incurred by the LLC. However, in the case of a single-member LLC that elects to be treated as a corporation under the “check-the-box” regulations, the LLC is liable for employment taxes incurred by the LLC, and the single member will not be liable for the employment taxes of the LLC unless the Service can “pierce the corporate veil” or hold the single member liable as a responsible person under the 100% penalty provisions. [See IRC 6672].

ILM 199930013 holds that as a general rule the IRS may not levy on the assets of a single-member LLC (regardless of whether it is disregarded for tax purposes) to collect a tax liability of its owner. They can only collect from the property of the taxpayer to satisfy taxpayer’s liability. The mere fact that the disregarded entity is disregarded for federal tax purposes does not entitle the Service to disregard the entity for purposes of collection. In so doing, the Legal Memorandum notes:

We do not believe that it is inconsistent to disregard an LLC entity for purposes of determining federal tax liability, but to recognize the LLC as a valid entity for determining what property the taxpayer has an ownership interest in under state law. This result follows from the general principal that state law determines what property a taxpayer has an interest in for purposes of tax collection.

The Legal Memorandum did discuss other methods available to the IRS to reach the assets of the single-member LLC. First, the IRS can lien and levy upon the member’s distributional interest. To the extent the state law governs the rights of creditors, a charging order may be the exclusive method for enforcing the claim of a creditor of a member against the LLC, depending upon the state LLC statute.

In at least one case in which the disregarded entity paid the owner’s income tax liability in connection with the disregarded entity’s income, the payment was found to be wrongful when the disregarded entity subsequently filed bankruptcy. This occurred in *In re KRSM Properties, LLC (Gilliam v. Speier)*, 318 B.R. 712 (9th Cir. BAP 2004), in which a Bankruptcy Appellate Panel held that the payment by a disregarded entity of \$136,000 to the IRS and California Franchise Tax Board to pay estimated personal taxes owed by the owners, at least some of which taxes related to capital gains on the sale of real property owned by the LLC, was wrongful and held that the amounts paid had to be returned to the disregarded entity, presumably leaving the owner to pay the taxes with respect to the income in the LLC.

In *McNamee v Department of the Treasury*, 488 F.3d 100 (2nd Cir. 2007), *Littriello v. US*, 484 F.3d 372 (6th Cir. 2007), and *L & L Holding Company, L.L.C. v. United States*,

Baringer
Advance Tax Issues

101AFTR2d 2008-2081, 20081 USTC 50,324, 2008 WL 1908840 (W.D. La April 30, 2008), the courts held the check-the-box regulations valid insofar as disregarded entities and employment taxes were concerned, thus validating the IRS actions in proceeding through assessment, tax liens and levies against the single member of a disregarded single member LLC for the payroll taxes attributable to the LLC employees. In *L & L Holding Company, L.L.C. v. United States*, 101AFTR2d 2008-2081, 20081 USTC 50,324, 2008 WL 1908840 (W.D. La April 30, 2008), the IRS filed tax liens against two members of a disregarded LLC for unpaid employment and unemployment taxes owed by the LLC. Each member filed suit challenging the IRS determination that the liens were valid. The suits were consolidated. The court rejected the plaintiffs' argument that the employment tax statute and the check-the-box regulations were in conflict. The court determined the check-the-box regulations were actually in harmony with the employment tax statute as they resolved an ambiguity in how to treat an LLC for employment tax purposes. The court ruled the IRS interpretation of the check-the-box regulations was correct as applied to the levy of employment taxes and the filing of related tax liens against successive owners of a single member LLC that did not check-the-box to be taxed as a corporation.

In *Littriello v. US*, (*supra*), the 6th Circuit held similarly. In disposing of the LLC single member's argument that the proposed regulations should be taken as reflecting the current Treasury Department policy and applied to the case which arose before the effective date of the new regulations, the court, relying on *Commodity Futures Trading Commission v Schor*, 478 U.S. 833, 106 S.Ct. 3245, 92 L.Ed.2d 675 (1986), concluded that "because the further development of permissible alternatives [to a current regulation] is part of the administering agency's function under [*Chevron U.S.A., Inc. v. National Res.Def. Council, Inc.*, 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984)], the proposed regulations do not in any way undermine the District Court's determination that the current regulations are reasonable and valid." Plainly, an agency does not lose its entitlement to Chevron deference merely because it subsequently proposes a different approach in its regulations."

In *Seymour v. United States*, No. 4:06-CV-116, 2008 WL 2509831 (W.D. Ky. June 19, 2008), the court concluded that the sole member of an LLC was personally liable for employment taxes owed by the LLC. The LLC leased the restaurant and obtained a liquor license, but the member argued that she did not authorize anyone to operate a restaurant under the auspices of her LLC and that she had a "gentlemen's agreement" with another individual who was to operate the restaurant. The court stated that whether the operation of the restaurant under the legal identity of the LLC was within the understanding of the "gentlemen's agreement" was a matter between the member and the other individual and did not affect the member's liability for the employment taxes. The court also found that the bookkeeper for the restaurant was personally liable although he was not the owner of the LLC and was not provided funds to pay the taxes. The bookkeeper had authority to sign checks for the LLC and was responsible for calculating payroll taxes and filing payroll tax returns; therefore, he was a "responsible person" under Section 6672(a). The court determined his conduct was "willful" because he knew about the delinquent taxes and chose to pay other creditors before paying the government.

Baringer
Advance Tax Issues

Thus, prior to certain amendments to the check-the box regulations that became effective January 1, 2009, the sole member of an LLC that had not elected to be classified as a corporation was liable for not only the employment trust fund taxes but also the employer taxes (employer FICA and Medicare tax) that were not remitted, it being reasoned that as the LLC is a “disregarded entity,” the sole member is the employer. See also Kandi v. United States, 97 AFTR 2d 721, 2006-1 USTC ¶ 50, 231 (W.D. Wash. 2006), aff’d 295 Fed. Appx. 873, 2008 WL 4429296 (9th Cir, 2008); Stearn & Co., LLC v. United States, 499 F. Supp.2d 899 (E.D. Mich. 2007).

In what may be the last effort attacking the former check-the-box regulation as unlawful line of reasoning, on March 31, 2009, the Tax Court issued its ruling Medical Practice Solutions, LLC v. Commissioner, 132 T.C. No. 7, in which, citing Litriello and McNamee, an apparently ill advised and unsupported effort to set aside the application of the check-the-box regulations was quickly dismissed. While the court noted that the check-the-box regulations have been now prospectively altered, such did not give rise to a claim that the prior regulations were in any manner unreasonable.

Amendment of the Check-the-Box Regulations for Employment & Excise Taxes

On October 18, 2005, the IRS issued Proposed Regulations within §301.7701-2 under which disregarded entities – single member eligible entities and qualified subchapter S subsidiaries – would be liable for their own excise and employment tax obligations. These regulations became final in 2008 and have now changed the rules, with the employment tax changes being effective January 1, 2009. Treas. Reg. §301.7701-2(c)(2)(iv) provides a special rule which excepts employment taxes and certain excise taxes from the disregarded entity rules for single member entities. Under these regulations, the single member LLC that has not elected to be classified as a corporation is “treated as an entity separate from its owner for purposes of subtitle C of the Internal Revenue Code.” All provisions of law (including penalties) and the regulations prescribed in pursuance of law applicable to employers in respect of such acts as are required of an employer are applicable to the single member LLC. The same rule applies for purposes of certain excise taxes.

Thus, the new regulations have eliminated disregarded entity status for purposes of federal employment taxes. The disregarded entity is now liable for employment taxes on wages paid to its employees of the disregarded entity, and is responsible for satisfying other employment tax obligations such as backup withholding, making deposits of employment taxes, filing returns, and providing Forms W-2.

The single member/owner of the disregarded entity is no longer liable for employment taxes or for satisfying other employment tax obligations with respect to the employees of the disregarded entity, except to the extent such person(s) may be held responsible under the 100% penalty assessment process. The disregarded entity will continue to be disregarded for all other

Baringer
Advance Tax Issues

Federal tax purposes so that, for example, an individual owner of a disregarded entity continues to be treated as self-employed for purposes of self employment tax, and not as an employee of the disregarded entity for employment tax purposes.

The new regulations are found in Treas. Reg. §301.7701-2(c) and provide as follows:

(c) Other business entities. For federal tax purposes—

(1) The term *partnership* means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.

(2) Wholly owned entities.

(i) In general. 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.

(ii) Special rule for certain business entities. If the single owner of a business entity is a bank (as defined in section 581, or, in the case of a foreign bank, as defined in section 585(a)(2)(B) without regard to the second sentence thereof), then the special rules applicable to banks under the Internal Revenue Code will continue to apply to the single owner as if the wholly owned entity were a separate entity. For this purpose, the special rules applicable to banks under the Internal Revenue Code do not include the rules under sections 864(c), 882(c), and 884.

(iii) Tax liabilities of certain disregarded entities.

(A) In general. An entity that is otherwise disregarded as separate from its owner is treated as an entity separate from its owner for purposes of:

- (1) Federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded.
- (2) Federal tax liabilities of any other entity for which the entity is liable.
- (3) Refunds or credits of Federal tax.

(B) Examples. The following examples illustrate the application of paragraph (c)(2)(iii)(A) of this section:

Example (1). In 2001, X, a domestic corporation

Baringer
Advance Tax Issues

that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, Z is the successor to X and is liable for all of X's debts. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2000 taxable year. Because Z is the successor to X and is liable for X's 2000 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations.

Example (2). The facts are the same as in Example 1, except that in 2002, the IRS determines that X miscalculated and underreported its income tax liability for 2000. Because Z is the successor to X and is liable for X's 2000 taxes that remain unpaid, the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.

(iv) Special rule for employment tax purposes.

(A) In general. Paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code). Paragraph (c)(2)(i) of this section does apply to taxes imposed under Subtitle A, including Chapter 2—Tax on Self-Employment Income. The owner of an entity that is treated in the same manner as a sole proprietorship under paragraph (a) of this section will be subject to the tax on self-employment income.

(B) Treatment of entity. An entity that is otherwise disregarded as an entity separate from its owner but for paragraph (c)(2)(iv)(A) of this section is treated as a corporation with respect to taxes imposed under Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal

Revenue Code).

(C) Example. The following example illustrates the application of paragraph (c)(2)(iv) of this section:

Example. (i) LLCA is an eligible entity owned by individual A and is generally disregarded as an entity separate from its owner for Federal tax purposes. However, LLCA is treated as an entity separate from its owner for purposes of subtitle C of the Internal Revenue Code. LLCA has employees and pays wages as defined in sections 3121(a), 3306(b), and 3401(a).

(ii) LLCA is subject to the provisions of subtitle C of the Internal Revenue Code and related provisions under 26 CFR subchapter C, Employment Taxes and Collection of Income Tax at Source, parts 31 through 39. Accordingly, LLCA is required to perform such acts as are required of an employer under those provisions of the Internal Revenue Code and regulations thereunder that apply. All provisions of law (including penalties) and the regulations prescribed in pursuance of law applicable to employers in respect of such acts are applicable to LLCA. Thus, for example, LLCA is liable for income tax withholding, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes. See sections 3402 and 3403 (relating to income tax withholding); 3102(b) and 3111 (relating to FICA taxes), and 3301 (relating to FUTA taxes). In addition, LLCA must file under its name and EIN the applicable Forms in the 94X series, for example, Form 941, "Employer's Quarterly Employment Tax Return," Form 940, "Employer's Annual Federal Unemployment Tax Return;" file with the Social Security Administration and furnish to LLCA's employees statements on Forms W-2, "Wage and Tax Statement;" and make timely employment tax deposits. See §§31.6011(a)-1, 31.6011(a)-3, 31.6051-1, 31.6051-2, and 31.6302-1 of this chapter.

(iii) A is self-employed for purposes of subtitle A, chapter 2, Tax on Self-Employment Income, of the Internal Revenue Code. Thus, A is subject to tax under section 1401 on A's net earnings from self-employment with respect to LLCA's activities. A is not an employee of LLCA for purposes of subtitle C of the Internal Revenue Code. Because LLCA is treated as a sole proprietorship of A for income tax purposes, A is entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through LLCA, including the employer's share of employment taxes imposed under sections 3111 and 3301, on A's Form 1040, Schedule C, "Profit or Loss for Business (Sole Proprietorship)."

(v) Special rule for certain excise tax purposes.

(A) In general. Paragraph (c)(2)(i) of this section (relating to certain wholly owned entities) does not apply for purposes of—

- (1) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), and 38 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;
- (2) Collection of tax imposed by Chapter 33 of the Internal Revenue Code;
- (3) Registration under sections 4101, 4222, and 4412; and
- (4) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (c)(2)(v)(A)(1) of this section or under section 6426 or 6427.

These new regulations for employment taxes became effective January 1, 2009. The new regulations for excise taxes became effective January 1, 2008.

2. **Guaranteed Payments:**

For LLCs taxed as partnerships, members can receive payments from the LLC either as distributions with respect to their membership interest or as payments which are made to the member (partner for tax purposes) in his capacity other than as a member (partner for tax purposes).

Baringer
Advance Tax Issues

Thus, in addition to being entitled to a share of the partnership's profits and losses, member/partners may also be given guaranteed payments for their capital or services. [IRC §707]. These are payments of fixed amounts that do not depend on the profits of the business. §707 provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, subject to certain exceptions, the transaction is considered as occurring between the partnership and one who is not a partner. The value of fringe benefits given to partners in return for their services, such as health insurance, is also considered a guaranteed payment. The partnership deducts guaranteed payments as ordinary business expenses, and the partners include them in income as ordinary income - self employment income if the payments are for services.

Guaranteed payments that are for services rendered to the tax partnership are subject to self-employment tax. Guaranteed payments for things such as rent or interest would not be subject to self-employment tax.

F. Planning for Self-Employment Tax

Self-employment tax consists of two components: (a) the old age, survivors, and disability insurance component of the self-employment tax is computed at a rate of 12.4% on the first \$106,800.00 of an individual's self-employment income [IRC §1401(a), 1402(b), 3121(a)(1)] for 2009; and (b) the hospital insurance component of the self-employment tax is computed at a rate of 2.9% on all of an individual's net earnings from self-employment. IRC §1401(b). An individual may deduct one-half of his or her self-employment taxes for the taxable year as an above the line deduction. IRC §164(f). This deduction, however, does not place the self-employed person on an equal footing with an employee whose employer pays one-half of the FICA and Medicare taxes. Robert Keatinge, John Maxfield and Thomas Yearout provided the following table of the effective rates of self-employment taxes under the 2006 contribution limits which takes into account the deduction of one-half of the self-employment taxes:⁹

Marginal Inc Tax Rate	Effective Rate on NESE ≥\$106,800	Effective Rate on NESE ≤ \$106,800
0%	2.9%	15.3%
10%	2.755%	14.535%
15%	2.6825%	14.1525%

⁹ Keatinge, Maxfield & Yearout, "Compensatory Issues in Passthrough Entities: Self-Employment and Employment Tax Issues and Issuance of Interests as Compensation, February 2, 2006, ALI-ABA Law Review Choice of Entity - 2006: Selecting Legal Form and Structure for Closely-Held Businesses and Ventures.

25%	2.5375%	13.3875%
28%	2.494%	13.158%
33%	2.4215%	12.7755%
35%	2.3925%	12.6225%

If tax rates revert to pre-2003 rates, the deduction for one-half the self-employment tax under the highest marginal rate (39.6%) will result in an effective rate of 12.2706% of net earnings from self-employment up to the OASDI benefit base and 2.3258% for self-employment income in excess of the benefits base.

With respect to payments by an employer to an employee, for 2008, each of the employer and the employee are subject to an employment tax of 6.2% on the first \$102,000 of wages paid to the employee, for a combined percentage of 12.4%.. IRC §§3101(a), 3111(a). In addition, each of the employer and the employee must pay a Medicare hospital tax on the total (uncapped) amount of wages equal to 1.45%, for a combined percentage of 2.9%. IRC §§3101(b), 3111(b).

Self-employment income which is subject to self-employment tax generally is defined as “the net earnings from self-employment” (“NESE”). IRC §1402(b). A general partner’s net earnings from self-employment generally include the partner’s distributive share of the partnership’s net income derived from a trade or business. IRC §1402(a); Treas. Reg. §1.1402(a)-1(a), §1.1402(a)-2(d). A limited partner does not include in net earnings from self-employment any item of partnership income or loss other than guaranteed payments under IRC §707(c) to the limited partner for services rendered to the partnership. IRC §1402(a)(13). The purpose of this exclusion is to prevent investors who do not perform services from qualifying for social security benefits based on passive investment activity. H.R. Rep. No. 702, 95th Cong., 1st Sess. pt. 1, at 11.

The IRS issued a first set of proposed regulations in 1994 which only applied to LLCs. A second set of proposed regulations was issued on 1/16/97 that applied to both LLCs and limited partnerships. Prop. Reg. 1.1402(a)-2. These latter proposed regulations were so controversial that Congress provided in the 1997 Tax Act that the IRS could not issue or make effective temporary or final regulations under §1402(a)(13) before July 1, 1998. Present reports are that the regulation project is not closed, but the IRS has not addressed the subject yet. The IRS appears to be awaiting Congressional guidance, as the moratorium has long since passed.

The 1997 proposed regulations completely redefine “limited partner” for purposes of §1402(a)(13) by creating three functional tests to be applied to “partnership” type entities (general partnerships, limited partnerships, LLCs, LLPs and LLLPs), rather than relying upon state law definitions. An owner is considered a limited partner, unless he fails one of the following three tests (or meets one of the two exceptions discussed):

Baringer
Advance Tax Issues

1. Liability test - The owner has personal liability for all obligations of the entity, which is determined by reason of being a partner under state law, not because of contractual guarantees or because of personal conduct.
2. Management test - The owner has authority to bind the entity which is determined under the law of the jurisdiction in which the entity was formed.
3. Participation test - The owner participates for more than 500 hours during the year.

There are two exceptions whereby one can still be considered a limited partner, if the taxpayer fails one of the foregoing three tests:

1. Multiple class exception - One can qualify for limited partner status, if one flunks one of the three tests above, with respect to a second class of interests, if:
 - A. Other limited partners own a substantial, continuing interest in the second class of interest. “Substantial” is a facts and circumstances determination, but the proposed regulations provide a 20% or more safe harbor. The proposed regulations do not contain any definition of “continuing.”
 - B. The individual’s rights with respect to the second class are identical to those holding the second class of interest (excluding the mere receipt of a guaranteed payment).

Guaranteed payments - Receipt of a guaranteed payment does not mean that interests of limited partners are not identical. Moreover, a “limited partner” who receives a guaranteed payment still counts towards satisfying the 20% test.
2. Material participation exception - If there is no second class of interest, and the partner flunks the 500-hour test, the partner can still qualify as a limited partner where the partnership interest is identical (excluding the mere receipt of a guaranteed payment) to the interest held by other “limited partners” holding a substantial, continuing interest. The same 20% safe harbor exists as in the case of the multiple class exception.

The proposed regulations take the position that a member of a personal service partnership cannot qualify for the limited partner exception. Some tax professionals are taking the position that so long as reasonable compensation is being paid, all other income paid to an

LLC member, whether a manager or a non-managing member, is exempt from self-employment tax. Other more conservative tax professionals take the position that, because an LLC member is not covered by the statute, one must either follow the statute or follow the Proposed Regulations.

Bona fide partners are not “employees” for purposes of federal employment tax. Rev. Rul. 69-184, 1969-1 C.B. 256. Thus, if an individual is a partner for federal income tax purposes, that person will not be treated as an employee, regardless of the terminology used to describe the relationship. If instead, an individual who provides services is not a partner for tax purposes, that individual may be considered to be either an employee or an independent contractor. An individual’s being characterized as an employee or a partner will have an effect on both the individual and the partnership.

Some practitioners choose the S corporation as the best choice of entity in which to conduct an active trade or business because of the ability of the S corporation to distribute pass-through income of the corporation without it being subjected to self-employment taxes. As long as a reasonable salary is paid which is subject to employment taxes, this allows taxpayers to avoid the 2.9% self-employment Medicare tax which applies on unlimited earnings from self-employment, or the 1.45% employee withheld Medicare tax and the 1.45% employer Medicare tax which likewise applies without limit. It should be noted, however, that the choice may also determine who bears the cost of one half the self-employment tax or the employer’s portion of the employment tax if the payee is a minority owner. Finally, it should also be kept in mind that the IRS has assessed employment taxes where S corporation shareholders have paid themselves unreasonably low salaries (actually, the cases deal with situations in which no wages were paid). Spicer Accounting Inc. v. United States, 918 F.2d 90 (9th Cir. 1990); Radtke, S.C. v. United States, 712 F.Supp. 143 (E.D. Wis. 1989), aff’d. per curiam 895 f.2d 1196 (7th Cir. 1990); Dunn & Clark v. Commissioner, 853 F.Supp. 365, 367 (D.Idaho 1994); Joly v. Commissioner, T.C. Memo 1998-361 (1998).

Because the amount included as net earnings from self-employment is based on the distributive share of earnings reported by partners in a partnership, rather than receipt of distributions, a general partner incurs self-employment tax regardless of whether there is any distribution to the general partner.

Under the 1997 Regulations a general partner in a limited partnership would generally continue to be required to include the general partner’s distributive share income as self-employment income because a general partner has vicarious liability for partnership debts and has authority under the partnership law to bind the partnership. A general partner in a limited partnership might be able to exclude some portion of his or her distributive share of income under the two classes of interest test.

On January 27, 2005, in response to an inquiry by the Senate Finance Committee, the staff of the Joint Committee on Taxation (“JCT”) issued a report JCS-02-05 entitled “Options to

Baringer
Advance Tax Issues

Improve Tax Compliance and Reform Tax Expenditures (the “JCT Report”). Among other things, the JCT Report proposed that S corporations be treated as partnerships and any shareholders of S corporations be treated as general partners.¹⁰ Under this proposal, S corporation shareholders would be subject to self-employment tax on their shares of S corporation net income (whether or not distributed) or loss in the same manner as partners. Current self-employment tax rules exclude from net earnings from self-employment of a shareholder certain types of income, such as certain rental income, dividends and interest, certain gains, and other items. Under the JCT proposal, in the case of a service business, all of the shareholder’s net income from the S corporation would be treated as net earnings from self-employment. A service S corporation is one, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to sec. 448(d)(d)).

On May 25, 2005, J. Russell George, Treasury Inspector General for Tax Administration testified before the Senate Finance Committee.¹¹ The Inspector General complained that employment tax inequities exist between sole proprietorships and single shareholder owned S Corporations, noting that the amount of potential employment tax collections lost in 2000 was \$5.7 billion based on a comparison of the profits of single-shareholder S Corporations and the amounts shown by the single shareholder as compensation subject to employment tax. Comments during the course of the hearing reflect significant animosity on the part of the regulators toward the perceived abuses by the single shareholder S Corporations which suggest that this appears to have developed into a case of the proverbial gilding of the lilly.¹²

¹⁰ See Keatinge, Maxfield & Yearout citing JCS-2-05: Options To Improve Tax Compliance And Reform Tax Expenditures at www.house.gov/jct/s-2-05.pdf at page 95. Similar provisions have been included in Summary of Joint Committee Staff “Options to Improve Tax Compliance and Reform Tax Expenditures” Joint Committee on Taxation April 12, 2005 JCX-19-05R at <http://finance.senate.gov/hearings/testimony/2005test/gytest041405.pdf> at page 9 and Testimony of George K. Yin, Chief of Staff of the Joint Committee on Taxation at a Hearing of the Senate Committee on Finance on “Social Security: Achieving Sustainable Solvency” May 2, 2005 JCX-38-05 at <http://finance.senate.gov/hearings/testimony/2005test/gytest052505.pdf> at page 2. Other information should be available on the Senate Finance Committee website: <http://finance.senate.gov>.

¹¹ See Keatinge, Maxfield & Yearout, indicating reports from the committee testimony should be available at <http://finance.senate.gov/sitepages/hearing052505.htm>.

¹² A memorandum date May 20, 2005 from Pamela Gardiner transmitting a report of the Treasury Inspector General for Tax Administration (TIGTA) entitled “Actions Are Needed to Eliminate Inequities in the Employment Tax Liabilities of Sole Proprietorships and Single-Shareholder S Corporations” Reference No. 2005-30-080 (May 2005) includes:

To eliminate the employment tax shelter for most S corporations, increase Social Security and Medicare employment tax revenues by \$30.8 billion and \$30.2 billion respectively between Calendar Years 2006 and 2010, provide for equitable employment tax treatment of taxpayers, and reduce the burden on IRS examination resources, we recommended the IRS Commissioner inform the Assistant Secretary of the Treasury for Tax Policy of the detrimental effects discussed in this report of Revenue Ruling 59-221 that was apparently issued under the historically inaccurate assumption that most S corporations would

Baringer
Advance Tax Issues

Under the JCT Report recommendation, any partner or S corporation shareholder who materially participates in the business of the partnership or S corporation would be treated generally under the net earnings from self employment rules applicable to a general partner. In a service entity, all of the owner's net income from the entity - presumably including the partner's or shareholder's distributive share of interest, rent, dividend and capital gain - would be treated as NESE.¹³ If becomes law, a partner or S corporation shareholder in a personal service business would include more in NESE than would a sole proprietor, who would still be able to exclude capital gains, rent, dividends and interest. The JCT Report recommends that in the case of any partner or shareholder who does not materially participate in the trade or business of the partnership or S corporation, a special rule would provide that only the partner's or shareholder's reasonable compensation from the entity is treated as NESE.

Treatment of Limited Partners

Under the IRC, notwithstanding the general rule that a partner's distributive share of income constitutes NESE, NESE does not include a limited partner's distributive share of income or loss other than distributions that are guaranteed payments as compensation for services to the extent that it is actually established that those payments are remuneration for services to the partnership.¹⁴ To the extent that a member is treated as a limited partner for purposes of that section, the member's distributive share of income from an LLC will not be NESE. The committee reports indicate that this provision was added to prevent passive investors who do not perform services from obtaining social security coverage.¹⁵ The committee reports also indicate that the provision is intended to be applied separately to limited partnership interests and general partnership interests, even where held by the same partner. Although there have not been regulations identifying limited partners for the purposes of this exclusion, the legislative history and the language of the statute both suggest that a member who actually participates in providing services should be required to include at least the distributions directly attributable to those services. Whether the statute exempts other types of distributive shares

involved multiple shareholders. The IRS Commissioner should consult with Treasury regarding the detrimental effects of Revenue Rule 59-221 should be reversed through the issuance of new regulations or through the drafting of new legislation, either of which should subject all ordinary operating gains of an S corporation that accrue to a shareholder (including the shareholder's spouse and dependent children) holding more than 50 percent of the stock in the S corporation to employment taxes.

¹³A service entity is an entity, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (similar to IRC § 448(d)(2))

¹⁴IRC § 1402(a)(13); Rev.Rul. 79-53, 1979-1 CB 286

¹⁵House Committee Report on Pub L No 95-216, 91 Stat 1509 (1977)

remains to be seen. This area requires at least administrative, and possibly statutory, clarification.¹⁶

The 1997 Proposed Regulations would generally allow a limited partner to exclude his or his distributable share of income from NESE unless the limited partner participated for more than 500 hours or the business was a personal service business.

The JCT proposal would eliminate the distinction between general partners and limited partners, a limited partner would be subject to the same NESE rules as apply to a general partner described above.

Treatment of Members of LLCs

A member's share of the income of an LLC must be classified in one of three ways: as NESE,¹⁷ as wages,¹⁸ or as a distribution of partnership income¹⁹ which is neither wages nor NESE. This classification also affects whether the income may serve as a basis for contributions to a qualified plan.

Revenue Rule 91-26,²⁰ provides that amounts paid by a partnership to or for the benefit of its partners, without regard to the income of the partnership, for services rendered in their capacities as partners, are guaranteed payments under IRC § 707(c). Under IRC § 61(a), the amount or the value of the benefit is included in the income of the recipient-partner. The amount or value of the benefit is not excludible from the partner's gross income under the general fringe benefit rules (except to the extent the IRC provision allowing exclusion of a fringe benefit specifically provides that it applies to partners) because the benefit is treated as a distributive share of partnership income under Section § 1.707-1(c) of the regulations for purposes of all sections of the IRC other than IRC §§ 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income.

For purposes of contributions to qualified pension, profit-sharing, and stock bonus plans, income from self-employment is included if it is derived from a trade or business in which the member's personal services are a material income-producing factor.²¹ Thus, if income from an LLC is not treated as either self-employment income or wages, it will not support contributions

¹⁶ See Keatinge, *Maxfield & Yearout*, at p. 16.

¹⁷ IRC § 1402(a)

¹⁸ IRC § 3121(a)

¹⁹ IRC § § 702, 731

²⁰ Rev Rul 91-26, 1991-1 CB 184

²¹ IRC § 401(c)(2)(A)(i)

to qualified plans.

In determining the treatment of payments to a partner, the legal relationship between the payor and the person compensated for the services is first reviewed to determine if the relationship of employer-employee exists.²² If that relationship exists, even if the person is designated as a partner, the payments will be wages.²³ In determining whether a payment for services made to a partner other than in his capacity as a partner under IRC § 707(a) constitutes wages under IRC § 3121(a), the test has been whether the partner is a bona fide partner, in which case the partner is not an employee of the partnership within the meaning of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages Act.²⁴

In Rev. Rul 69-183, the IRS ruled that two purported partners in a partnership that was providing services for a corporation were subject to the direction and control of the corporation, and were, therefore, treated as employees of the corporation.²⁵ Thus, if the services are provided to the partnership, they will not be treated as wages. The effect of this ruling would seem to be that if services are performed for a partnership, but the services are actually rendered as common-law employees to an entity other than the partnership, the partnership will be disregarded and the payments will be treated as wages.

Revenue Ruling 69-184 holds that a partner who devotes his time and energies in the conduct of the trade or business of the partnership is a self-employed individual rather than an employee. If a member was a “self-employed individual,”²⁶ the member could participate in a plan. Under the definition, a self-employed individual is an individual who has earned income in any year. Under IRC § 401(c)(2), “earned income” is net earnings from self-employment as defined in IRC § 1402(a). IRC § 1402(a) defines “NESE” as the gross income derived by an individual from any trade or business carried on by such individual plus the distributive share of income or loss described in IRC § 702(a)(8). IRC § 1402(a)(13) excludes from NESE the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in IRC § 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that the guaranteed payment is established to be remuneration for those services.

²²Reg. § 31.3121(d)-1(a)(3)

²³See GCM 34001 and GCM 34173

²⁴Chapters 21, 23, and 24 respectively, subtitle C, Internal Revenue Code of 1954; Rev Rul 69-184, 1969-1 CB 256

²⁵Rev. Rul 69-183, 1969-1 CB 255

²⁶As defined in IRC § 401 (c) (1)

The statutory language suggests that the distributive share of a person who is not a limited partner would be NESE. For example, in Revenue Rule 58-166,²⁷ a taxpayer acquired a fractional working interest in an oil and gas lease, under the terms of which the taxpayer appointed the owner as his agent and delegated to him complete authority to manage and control the development and operation of properties involving the lease. The ruling holds that the taxpayer's earnings from the organization constitute self-employment income regardless of his limited involvement in the organization. Similarly, *Gamma Farms v. United States*,²⁸ dealt with a partner in a defectively formed limited partnership which neglected to file the Certificate of Limited Partnership with the state. The trial court held that as a result, the intended limited partner a general partner and, therefore, was required to pay self-employment tax. The decision in *Gamma Farms* was reversed based on the good faith reliance of the limited partners on the fact that the certificate would be filed.²⁹ The court cited the amendment to the California Limited Partnership Act that allowed a limited partner who is erroneously identified as a general partner to correct the record and avoid liability.³⁰

In Private Letter Ruling 9110003,³¹ the IRS noted that neither the IRC nor the regulations define the terms "limited partnership" or "limited partner" for the purpose of determining "net income from self-employment." In that private letter ruling, the failure to file a certificate of limited partnership as required by the state statute was held to cause the purported limited partner to be treated as general partner for purposes of IRC § 1402(a).

The current rules may cause those with passive investments in an LLC to be required to treat income as NESE. IRC § 1402(a) begins with a presumption that a distributive share of income from a general partnership is net income from self-employment. Many forms of income are then excluded from this rule. As noted above, net income from self-employment will not include a general partner's share of rental income,³² dividends and interest,³³ gains from the sale of capital assets,³⁴ and amounts paid on retirement of some partners.³⁵

The distributive share of income of a partnership whose activities are limited to

²⁷Rev Rul 58-166, 1958-1 CB 324

²⁸*Gamma Farms v. U.S.*, 1990 WL 107421, 66 AFTR2d 90-5252, 90-2 USTC 50,378 (ND Cal 1990)

²⁹*Gamma Farms v. U.S.*, 956 2d 1166 (CA9 1992)

³⁰ See *Keatinge, Maxfield & Yearout* at p. 18.

³¹Priv. Ltr. Rul. 9110003

³²IRC § 1402(a)(1)

³³IRC § 1402(a)(2)

³⁴IRC § 1402(a)(3)

³⁵IRC § 1402(a)(10)

investment in savings certificates and collection of interest thereon with respect to its membership accounts has been held not to be “net earnings from self-employment.”³⁶ *Keatinge, Maxfield & Yearout* suggest that the logical solution to the problem presented by the desire to treat participants in a personal services business as self-employed while excluding investors would seem to be to treat members of LLCs on a case-by-case or class-by-class basis. They suggest that to the extent that a general rule must be applied, it seems that the appropriate result is that the distributive shares of members should be net income from self-employment subject to the other statutory exclusions. They believe a better way to resolve the problems of investors would seem to be to clarify and expand the exclusions under IRC § 1402(a)(1), (2),(3), and (10). It may be possible to achieve the goals of IRC § 1402(a)(13), while treating passive investors as limited partners for purposes of IRC § 1402(a)(13), while treating active investors as general partners.³⁷

Keatinge, Maxfield & Yearout point out that the Health Security Act proposed in 1994 set forth a similar rule for limited partners and shareholders in S corporations, under which limited partners and S corporation shareholders who “materially participated” in the business of a limited partnership or S corporation engaged in a personal service trade or business would be treated as net income from self-employment. This could be done by treating those who are merely passive investors as limited partners while treating more active participants as general partners.

A “service-related business” would be any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees.

That the appropriate test should be the participation of the member in the activities is reflected in the discussion of this provision by the JCT Description and Analysis of Title VII of HR 3600, S. 1757, (“Health Security Act”). Prepared by the Staff of the Joint Committee on Taxation (Dec 20, 1993):

MATERIAL PARTICIPATION. Under the provision, a two-percent shareholder need not include his or her pro rata share of S corporation earnings as NESE [Net Income from Self-Employment] unless the shareholder materially participates in the activities of the S corporation. This test may be appropriate under the theory that a shareholder’s pro rata share of S corporation earnings is not remuneration for the services provided by the shareholder unless the shareholder materially participates in the activities of the corporation.

³⁶Rev. Rul. 75-525, 1975-2 CB 350

³⁷ See *Keatinge, Maxfield & Yearout* at p. 19.

Keatinge, Maxfield & Yearout feel that in many instances, the material participation test may be redundant with the two-percent shareholder test (e.g., in the case of an S corporation owned by a sole shareholder-employee). But where there are multiple shareholders with multiple duties, a determination as to the material participation of each shareholder would be required. These determinations may be difficult. The provision does not define “material participation.” The term is used under the Self-Employment Contributions Act (SECA) to include certain farm rental income as NESE,³⁸ as well as elsewhere in the IRC to determine whether an individual may deduct losses from certain activities in which he or she materially participates (the passive loss rule of IRC § 469). Under the passive loss rules, “material participation” means involvement in the operations of an activity on a basis that is “regular, continuous, and substantial,” a more rigorous test than under IRC § 1402. Regulations under IRC §§ 469 and 1402 provide further guidance as to when a taxpayer’s involvement constitutes material versus passive participation, for the respective purposes of the two provisions. Despite this guidance, however, the determination of “material participation” under either section is often thought to be a difficult and subjective process.³⁹

The provision also would apply a material participation test (but not the “two-percent shareholder” or “service-related trade or business” tests) to limited partners. Section 469 provides that, except as provided in regulations, the activities of limited partners do not constitute material participation. Treasury regulations provide instances in which the activities of a limited partner override this presumption. In general, it is more difficult for a limited partner to sustain material participation than it is for a general partner under IRC § 469.⁴⁰

In regard to very recent developments of note relative to the §469 passive activity rules as applied to LLCs, In *Thompson v. U.S.*, 104 AFTR2d 2009-5124 (Ct.Fed.Cl. 7/20/2009), a case of first impression for it, the Court of Federal Claims decisively rejected IRS's argument that a taxpayer's interest in an LLC should be treated as a limited partnership interest for purposes of the IRC §469 passive activity loss (“PAL”) rules. The Court concluded that the LLC was not a partnership under state law and therefore couldn't be treated as the equivalent of a limited partnership for PAL purposes. It also suggested that limited liability wasn't the determining factor in deciding whether a taxpayer's interest in an activity is passive; rather, Congress' primary concern was the level of involvement in the activity. While the decision is a victory for taxpayers, its applicability may be limited because it involved a taxpayer who was both a 99% direct owner in an LLC and its only manager.

Under the IRC § 469 passive activity rules, passive activity losses cannot offset nonpassive activity income, such as wages, dividends, or profits from nonpassive activities.

³⁸ IRC § 1402 (a)(1)

³⁹ See *Keatinge, Maxfield & Yearout* at p. 20.

⁴⁰ *Id.*

Passive activities include the conduct of trade or business activities in which the taxpayer doesn't materially participate and, generally, rental activities without regard to whether the taxpayer materially participates in them. IRC §469(c) & Reg. § 1.469-1T(e)(1). Under § 469(h)(1) , a taxpayer materially participates in an activity only if he is involved in the activity's operations on a regular, continuous, and substantial basis, which generally requires him to meet one of seven tests carried in Reg. § 1.469-5T(a). Under §469(h)(2) , a limited partner's interest in a limited partnership isn't treated as an interest in an activity in which the taxpayer materially participates, except to the extent provided in the regs. Thus, §469(h)(2) treats losses from an “interest in a limited partnership as a limited partner” as presumptively passive. Reg. § 1.469-5T(e)(2) provides that a limited partner clears the material participation hurdle only if he meets one of three tests (instead of the generally applicable one of seven tests). Reg. § 1.469-5T(e)(3)(i) provides that a partnership interest is treated as a limited partnership interest if:

... the interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of the interest for obligations of the partnership is limited under the applicable state law; or

... the liability of the holder of the interest for obligations of the partnership is limited under the law of the state in which the partnership is organized to a fixed amount. For example, state law could limit the liability of the partner to the sum of the partner's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership.

Under Reg. § 1.469-5T(e)(3)(ii) , a partnership interest isn't treated as a limited partnership interest for the individual's tax year if he is a general partner as well as a limited partner in the partnership during its tax year ending with or within the individual's tax year.

In another recent decision, the Tax Court held in *Garnett* (2009), 132 TC No. 19 , that taxpayers didn't hold their interests in limited liability partnerships (LLPs) and limited liability companies (LLCs) as “limited partners” for purposes of the special §469(h)(2) material participation provision under the PAL rules.⁴¹

The IRS contended in Thompson that under Reg. § 1.469-5T(e)(3)(i) , Thompson was a limited partner because he elected to have the LLC taxed as a partnership for income tax purposes and his liability was limited under state law. The Court countered that the reg applies, by its own terms, only if the ownership interest is in a business entity that is, in fact, a

⁴¹ See also, *Hegarty v. Commissioner of Internal Revenue*, 2009 WL 3188789, p. 2-3 (U.S. Tax. Ct. Oct. 6, 2009), in which the Tax Court confirmed its previous ruling in *Garnett* which stated that “the material participation of a taxpayer who participated in a business conducted through a limited liability company is determined with reference to any of the seven tests listed in section 1.469-5T(a)(1) through (7), Temporary Income Tax Regs., *supra*.”

partnership under state law, not merely taxed as a partnership under the Code. The LLC was an LLC under Texas law, not a limited partnership, so Thompson was a member of an LLC, not a limited partner. The IRS had conceded that Thompson would be a general partner if the LLC were a limited partnership. Nonetheless, IRS wanted to equate Thompson's interest in the LLC to that of a limited partner's interest in a limited partnership for purposes of Reg. § 1.469-5T(e)(3)(i), but wanted to deny him the possible benefit of the general partner exception in Reg. § 1.469-5T(e)(3)(ii) . The Court rejected this position as “entirely self-serving and inconsistent.”

The IRS also argued that when §469 and Reg. § 1.469-5T were promulgated, there was universal agreement among the states that the *sine qua non* of a limited partnership interest was limited liability. The Court's view was that when §469 was enacted, there was general agreement among state laws that a limited partner would lose his limited liability status if he participated in the control of the business. Stated another way, a limited partner's level of participation in the business dictated whether or not he enjoyed limited liability. But the converse is not true. Under the Uniform Limited Partnership Act (and its revisions), a limited partner who “takes part in the control of the business” becomes “liable as a general partner.” The Court said that, to be sure, loss of limited liability under state law likely deterred many limited partners from participating in the control of their businesses, but limited liability is not the *sine qua non* of a limited partnership interest. Moreover, the Court's analysis of the legislative history of §469 suggested that Congress was primarily concerned with the taxpayer's involvement in the activity in question. Had Congress wanted a test that turned on a taxpayer's level of liability, it would have so specified.

The Court in *Thompson* said IRS's interpretation of the Code conflicts with its plain language. §469(h)(2) specifies that “except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.” The purpose of Congress's grant of regulatory authority was to provide exceptions to—not expand upon—the Code's presumption that limited partners do not materially participate in their limited partnerships. The Court said that unlike a limited partnership, an LLC allows all members to participate in the business while retaining limited liability. Thus, it makes little sense to extend the Code's presumption about a limited partner's lack of participation in a limited partnership to Thompson and his LLC. Even if Reg. § 1.469-5T(e)(3) could apply to Thompson and the Court had to categorize his membership interest as either a limited or a general partner's interest, it would best be categorized as a general partner's interest under Reg. § 1.469-5T(e)(3)(ii) . At best, the Court said, IRS identified an ambiguity in Reg. § 1.469-5T(e)(3)(ii) as it applies to LLCs. However, the Court should decide such ambiguities in favor of the taxpayer. Therefore, Thompson could demonstrate his material participation in the LLC using all seven tests in Reg. § 1.469-5T(a) , rather than just three of them. Therefore, the Court ruled that §469 didn't limit Thompson's share of the LLC's losses, and directed IRS to refund \$781,241 to him for the 2002 and 2003 tax years, plus interest. Time will tell whether the courts will extend similar analysis to the employment tax and self-employment tax statutes and regulations before the IRS comes up with final regulations to deal specifically with the LLC in

this area.

Getting back to the employment tax arena, *Keatinge, Maxfield & Yearout* point out that although “material participation” may be an appropriate standard for determining when the activities of an S corporation shareholder or limited partner give rise to earnings that should be subject to self employment tax, the application of such a standard may be administratively difficult. Conversely, they say if the application of the standard proves to be administratively feasible, consideration should be given to applying the standard to general partners in partnerships as well. The problem seems to be, however, that the regulators and enough members in Congress seem determined to hold out for a simple mechanical rule that can be applied universally that for some 15 years or so now since the LLC caught on in the U.S., no real resolution to the problem has been adopted in either the legislative or regulatory arena.

The Tax Court has recently held that the determination of the treatment of individual owners of LLCs as having NESE that are partners in a general partnership that was subject to a TEFRA partnership-level proceeding is a nonpartnership item involving information not usually maintained by partnerships. Thus, the determination of the NESE of the members of the LLC could not be determined in the general partnership’s TEFRA proceeding.⁴²

The 1994 regulations

On December 29, 1994, Proposed Regulation § 1.1402(a)-18⁴³ (the “1994 Proposed Regulation”) was released dealing with “Self-Employment Tax Treatment of Members of Certain Limited Liability Companies.” Under these proposed regulations, a member of a manger-managed LLC would have treated as a limited partner for purposes of IRC § 1402(a)(13) if the member was not a manger of the LLC, and the LLC could have been formed as a limited partnership rather than an LLC in the same jurisdiction, and the member could have qualified as a limited partner in that limited partnership under applicable law.

For purposes of the 1994 Proposed Regulation, a “manager” was “a person who, alone or together with others, was vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed.” If there were no elected or designated managers, all members were treated as managers.⁴⁴

This regulation provided certain planning opportunities and risks. In the traditional investment partnership, with truly passive individual investors and active managers, the LLC should be manager-managed.

⁴²*Olsen-Smith, Ltd. V. Commissioner*, T.C. Mem 2005-174 (July 18, 2005)

⁴³59 Fed Reg. 67253

⁴⁴Prop Reg. § 1.1402 (a)-18 (c)(3)

There were two areas of uncertainty in the proposed regulation:

- (1) When is there an elected or designated manager? And
- (2) When would a member cease to be a limited partner if, instead of organizing an LLC, the members had formed the business as a limited partnership?

Under the 1994 Proposed Regulation, a member would have been treated as a limited partner if the LLC had designated or elected a manager and the member was not a manager. The proposed regulation suggested that there did not need to be a member-manager so that, at least for purposes of net income from self-employment, there was no member who was subject to self-employment taxes.⁴⁵

The second requirement under the proposed regulation, that the member could have qualified as a limited partner if the LLC were a limited partnership under applicable law, turned on the member's participation in the control of the LLC. Under RULPA § 303(a), a limited partner would be liable as a general partner if the partner participated in the control of the business. However, if the limited partner participated in the control of the business, the limited partner was liable only to persons who transacted business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner was a general partner. Thus, as long as the activity of the member was less than that necessary to subject a limited partner to liability under the limited partnership act of the state, the member should have been able to avoid self-employment tax.

The 1997 Regulations⁴⁶

On January 10, 1997, the Treasury withdrew the 1994 Proposed Regulations⁴⁷ and released new proposed regulations (the "1997 Regulations").⁴⁸ Unlike the 1994 Proposed Regulations, the 1997 Regulations provide rules for distinguishing between general partners and limited partners for all forms of unincorporated business organizations, including general and limited partnerships. Rather than adding new subsections to the regulations, the 1997 Regulations modify existing subsections to define "limited partner" in all tax partnerships.

⁴⁵Prior to the adoption of the "check-the-box" regulations, a manager-managed LLC without a member-manager would possess the corporate characteristic of centralized management, and the dissolution events and approval for the admission of transferees must be measured by reference to all of the remaining members. Rev Proc 95-10, 1995-1 CB 501

⁴⁶For a discussion of these matters, see, David C. Culpepper, Sanford Holo, Robert R Keatinge, Thomas C Lenz, Bahar A Schippel, Richard A Shapack, and Thomas E Yearout Self-Employment Taxes and Passthrough Entities: Where Are We Now? 2005 TNT 196-23 (October 17, 2005)

⁴⁷Withdrawal of notice of proposed rulemaking (Reg-209729-94) (RIN 1545-AS94) (January 10, 1997)

⁴⁸Proposed amendments to Reg § 1.1402-2 (Reg-209824-96) released January, 1997

The 1997 Regulations, while generally clear, rational and fair, drew a firestorm of criticism from Congress and others⁴⁹ because they applied to all tax partnerships, including state law limited partnerships, and, thus, in some highly unusual circumstances, might cause an individual's interest which would be characterized as a limited partnership interest under state law not to be treated as a limited partner for purposes of determining NESE.⁵⁰

The 1997 Regulations attempt to distinguish between distributive shares that are allocated to general partners and those allocated to limited partners. In light of the legislative history of the act that added IRC § 1402(a)(13), the 1997 Regulations also set forth rules dealing with the circumstance in which the same individual is both a general partner and a limited partner. The 1997 Regulations accomplish these objectives by setting forth rules for both partners (the individual members or partners) and for partnership interests (the interests that members or partners have to allocations of income or gain). Thus, a partner may have more than one partnership interest in a partnership, and the character of the partner's distributive share as NESE is determined by reference to the identity of the partner and the various partnership interests that the partner and others hold.⁵¹

Under the 1997 Regulations, a member will be treated as a limited partner unless one of four exceptions applies:⁵²

- The Liability Test The member has personal liability for the debts of

⁴⁹ See, e.g., letter from Christopher Bond to Robert Rubin, April 9, 1997; Archer, Roth Protest Limited Partnership Regs, 97 Tax Notes Today 70-41, (1997); Congressional Republicans Assail Limited Partnership Regs, 97 Tax Notes Today 70-6 (1997); Forbes Chides GOP Leaders for Waffling on Tax Cuts, 97 Tax Notes Today 69-5 (1997; Review and Outlook: Stealth Tax, Wall Street Journal, Monday, May 5, 1997 Section A; Page 18, Column 1

⁵⁰ See *Keatinge, Maxfield & Yearout* at p. 22. A state law limited partnership interest would be treated as not being a limited partnership interest for NESE purposes only if:

(1) the individual participates for more than 500 hours during the year in the activities of the limited partnership and does not hold an interest that is identical to the interest of a person who is treated as a limited partner under the 1997 Regulations; or

(2) the individual holding the interest provides more than a de minimis amount of services to a limited partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering architecture, accounting, actuarial science, or consulting. Thus, the circumstances in which the distributive share of income allocable to an individual's limited partnership interest would be subject to NESE are limited cases in which all limited partners either participated in the business or also hold general partnership interests or where the limited partnership is engaged in a licensed profession or consulting and the partner is providing services. Neither of these circumstances is common, and the individuals owning limited partnership interest who will be adversely affected by the 1997 Regulations should be very few, particularly in comparison to the large number of members of LLCs who will benefit from the certainty that the regulations provide. *Id.*

⁵¹ *Id.*

⁵² Prop Reg. § 1.1402 (a)-2(h)(2)

or claims against the LLC by reason of being a member;⁵³

- The Authority Test The member has authority (under the law of the jurisdiction in which the LLC is formed) to contract on behalf of the LLC⁵⁴
- The Participation Test The member participates in the trade or business of the LLC for more than 500 hours during its taxable year;⁵⁵ or
- The Personal Services Test The member provides more than a de minimis amount of services to or on behalf of the trade or business of an LLC, substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting⁵⁶

The 1997 Regulations, unlike the 1994 Proposed Regulations, provide that although an individual is not treated as a limited partner under the rules set forth above, the individual's distributive share of income attributable to certain partnership interests may be treated as the distributive share of a limited partner. In other words, the same individual who would otherwise be treated as a general partner may hold an interest as a limited partner. The 1997 Regulations accomplish this result by comparing a partnership interest of an individual treated as a general partner with interest held by individuals who would be treated as limited partners under the tests set forth above. These rules are designed to provide for the same results as would obtain in the case of a general partner who also holds a limited partnership interest. They accomplish this goal by testing both the member and the interest owned by the member.⁵⁷

There are two alternative tests under which the interest of a member who might otherwise be treated as a general partner will be treated as limited partnership interest:

- The Two Classes of Interest Test: An individual who is not treated as a limited partner under the liability test, the authority test or the participation test, may be

⁵³ Prop Reg § 1.1402(a)-2(h)(2)(i)

⁵⁴ Prop Reg § 1.1402(a)-2(h)(2)(ii)

⁵⁵ Prop Reg § 1.1402(a)-2(h)(2)(iii)

⁵⁶ Prop Reg § 1.1402(a)-2(h)(5)

⁵⁷ See *Keatinge, Maxfield & Yearout* at p. 23.

treated as a limited partner with respect to a second class of interest that meets certain requirements.⁵⁸ Under the regulations, the second class of interest must be held by persons who are treated as limited partners under the tests described above.⁵⁹ A person who is not treated as a limited partner as a result of the personal services test is not eligible for the two classes of interest exception.

- The Single Class of Interest Test: An individual who is not treated as a limited partner solely by virtue of participating for more than 500 hours in a year, may nonetheless be treated as a limited partner if that individual's rights and obligations by virtue of owning that interest are identical to the rights and interests of other partners who have substantial continuing interests in the partnership and who are treated as limited partners.⁶⁰ This provision would prevent a member of an LLC with one class of interest from being treated as a general partner simply by contributing 500 hours.

In order for the general partner to be able to take advantage of these rules, the limited partners must own a "substantial, continuing interest in a specific class of partnership interest."⁶¹ The 1997 Regulations provide that the ownership of 20% of a particular class of interest will be considered substantial.⁶² Under the 1997 Regulations, the distributive share attributable to a partnership interest of an individual who would otherwise be considered a general partner will be treated as the distributive share of a limited partner if that partnership interest is identical to the interest held by "limited partners within the meaning of paragraph (h)(2)."⁶³ Thus, to determine

⁵⁸ The proposed regulations define a *class of interest* as "an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest. Prop. Treas. Reg. § 1.1402(a)-2(h)(6)(i)

⁵⁹ The proposed Regulation provides that it applies to "Limited partners within the meaning of paragraph (h)(2)." Prop Reg. § 1.1402-2(h)(3). Under Prop Reg. § 1.1402-2(h)(2), all partners are limited partners unless they meet one of the liability test, the authority test, or the participation test. It is unclear whether a partner who fails the service test (i.e., is a service partner in a service partnership) but otherwise does not have personal liability or authority or participate for 500 hours a year would be a "limited partner within the meaning of paragraph (h)(2)." It appears that because Prop Reg § 1.1402-2(h)(5) provides that "an individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section" that a service partner in a service partnership would not be treated as a limited partner.

⁶⁰ Prop Reg. § 1.1402-2(h)(4)

⁶¹ Prop Reg. § 1.1402-2(h)(3)(i) and 1.1402-2(h)(4)(i)

⁶² Prop Reg. § 1.1402-2(h)(6)(iv)

⁶³ Prop Reg. § 1.1402-2(h)(3)(I) and 1.1402-2(h)(4)(i)

the applicability of the class of interest exceptions, one must determine who a “limited partner” is and what an “identical interest” is.⁶⁴

The 1997 Regulations suggest that the only partners who will be considered as “limited partners” are individuals. The interests being considered are interests held by “limited partners within the meaning of paragraph (h)(2).”⁶⁵ Proposed Regulation § 1.1402-2(h)(2) refers to individuals being treated as limited partners. A rigorous reading of the regulations would suggest that the limited partners owing the substantial continuing interest must be individuals. There is no policy reason for the requirement that the “limited partners” be individuals, but planners should carefully consider whether they will be able to take advantage of the 1997 Regulations with limited partners which are entities.⁶⁶

The question of whether the general partner’s rights and obligations with respect to a particular class of interest are identical to the rights and obligations of a limited partner also requires careful consideration. While the text of the 1997 Regulations does not explain what identical rights and obligations are, the example provides some guidance.⁶⁷

Example: A, B, and C form an LLC that is not a service partnership. The LLC allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute \$1x for one LLC unit. B contributes \$2x for two LLC units. Each LLC unit entitles its holder to receive 25% of LLC’s tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of \$6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of \$10x for 1000 hours of services rendered to the LLC. C also is elected the LLC’s manager. Under state law, C has the authority to contract on behalf of the LLC.⁶⁸

Based on the treatment of the members in the example, *See Keatinge, Maxfield & Yearout* submit that the following rules apply:

(1) A person elected as a manager will be not treated as a limited partner as a result of the application of the authority test. In other words, unlike a general partner who has authority as a direct result of being a general partner, a manager who also happens to be a member will be treated as having authority. It is not

⁶⁴ *See Keatinge, Maxfield & Yearout* at p. 24.

⁶⁵ Prop Reg § 1.1402-2(h)(3)(I) and 1.1402-2(h)(4)(I)

⁶⁶ *Id.*

⁶⁷ Prop Reg. § 1.1402-2(I)

⁶⁸ Prop Reg. § 1.1402-2(i)(I).

clear whether a member who is not designated as a manager but is given some authority to act on behalf of the LLC will be treated as having authority under state law, but it is probably wise to avoid unnecessary grants of authority to members in the operating agreement or elsewhere.⁶⁹

(2) Interests may be proportionate to capital accounts and still be identical. The example indicates that B's interest is identical to A's interest in spite of the fact that B's interest is exactly twice as large as A's interest.⁷⁰ It is not clear whether interests that had been acquired for services, but otherwise were identical to interests acquired for capital would be treated as identical for this purpose. For example, if A contributes \$100 for an interest and B receives an interest with a \$100 capital account in exchange for past services (and, presumably, recognizes \$100 of ordinary income on the receipt) but the interests are otherwise identical, the interests should be considered identical for purposes of the regulations. Informal discussions with government representatives have suggested that this is the correct result. In contrast, drafters may want to avoid interests that carry an obligation of future services or is subject to forfeiture out of concern that such an interest may not be identical in terms of rights and obligations.⁷¹

(3) Interests of two members may be identical in spite of the fact that one member is treated as a limited partner and the other is not a limited partner under the Participation Test. In this case, B's interest is treated as identical to A's even though B provides services while A does not. There is nothing in the text of the regulation which requires that B receive a guaranteed payment in order for the exception to apply, but in commenting on the payment for services the Proposed Regulation notes:⁷²

However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's

⁶⁹ See *Keatinge, Maxfield & Yearout* at p. 25. Prop Reg. § 1.1402-2(i)(i).

⁷⁰ Prop Reg. 1.1402-2(i)(iii).

⁷¹ *Id.*

⁷² *Id.*

distributive share attributable to B's two LLC units is not net earning from self-employment under section 1402(a)(13).

The authority test may be problematic for LLCs under some state's laws. Under the language of the regulations, a person will not be treated as a general partner unless "the individual—... Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership"⁷³ Under the Delaware Limited Liability Company Act-unlike most statutes-the fact that an LLC has a manager does not, in and of itself eliminate the agency authority of the members. Under the Delaware statute, "Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company."⁷⁴ At the very least, in the absence of a provision in the limited liability company agreement denying members *qua* members agency authority all members would be treated as general partners-regardless of whether the LLC had managers. Presumably, if a provision limiting the authority of members is included in the limited liability company agreement, the members would not have authority under the law of Delaware to bind the LLC and thus would not be general partners. The answer would turn on the meaning of the phrase "under the law of the jurisdiction in which the partnership is formed."

While the underpinning of the distinction under IRC § 1402(a)(13) is an attempt to distinguish between returns on capital and compensation for services, neither the statute nor the text express any requirement that the distributive share not be remuneration for services. The result should be the same even if there were no guaranteed payment for the services provided. A cautious drafter may wish to provide a guaranteed payment out of an abundance of caution to be in conformity with the regulation.⁷⁵

4. Interests of two members should be identical in spite of the fact that one member is treated as a limited partner and the other is not a limited partner under the Liability Test or the Authority Test. In this case, regardless of whether C's interest is treated as identical to A's, C will not be treated as a limited partner because the LLC does not have two classes of interest.⁷⁶ The result gives rise to an interesting drafting issue. What would the result be if, instead of one Unit, each of A and C bought 1 Class A Unit for \$1/2x and 1 Class B Unit for \$1/2x,

⁷³ Prop. Treas. Reg. § 1.1402(h)(2)(ii).

⁷⁴ 6 Del. Code 18-402.

⁷⁵ See *Keatinge, Maxfield & Yearout* at p. 26.

⁷⁶ Note that the Single Class of Interest Test only applies to a partner who is not treated as a limited partner under the Participation Test.

and B purchased 2 Class A Units for \$1x and 2 Class B Units for \$1x. Assume further that all Class A and Class B Units were identical and all other facts are as set forth in the example. In this case, C's interest in the LLC as represented by Class A Units should be treated as the interest of a limited partner under the Two Classes of Interest Test because A, a limited partner under the 1997 Regulations, owns a continuing substantial interest in the class A Units and the Class A Units are identical, and there are two classes of Units. Note that the same analysis should apply to the Class B Units, so that all of C's distributive share from Class A and Class B Units should be treated as net income from self-employment.

As noted above, the Two Classes of Interest Test allows a person who would not be treated as a limited partner as a result of any of the Liability Test, the Authority Test, or the Participation Test to be treated as a limited partner with respect to any interest with respect to which a limited partner owns an interest which is identical to the interest of a limited partner so long as there are two classes of interest. This test suggests that an interest will be considered identical even though the person owning the interest has individual liability and authority to bind, so long as the interests are otherwise identical. Under this analysis, it would appear that in an entity organized as a limited partnership under state law if each of the general partners and limited partners held interests in two classes, each class of which was identical, that the general partner's distributive share with respect to each of the classes would be treated as made to a limited partner. This result is counter-intuitive in that one would assume that, in a state law limited partnership, at least some interest of the general partner would be treated as not being a limited partner interest. Again, the cautious drafter may wish to provide for an interest that is only held by the general partner and a second interest held by all partners to avoid this result.⁷⁷

A 1997 report of the JCT⁷⁸ goes further than the proposed regulations suggesting that members and partners would be treated as employees with respect to all guaranteed payments for services under IRC § 707(a) or deemed non partner payments under IRC § (707)©. In addition, the distributive share of all limited partners or members of LLCs who participate in the business of the limited partnership or the LLC in excess of a certain number of hours would be treated as NESE except to the extent that such distributive share represents a return on the member or limited partner's capital account (determined by multiplying the capital account by an applicable federal rate.)⁷⁹

The Moratorium and Its Aftermath.

⁷⁷ See Keatinge, *Maxfield & Yearout* at p. 27.

⁷⁸ Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* 9JCS-6-97, J Comm Print 1997).

⁷⁹ JCT Report at pp 48 and 49.

The Moratorium.

Section 935 of the Taxpayer Relief Act of 1997⁸⁰ provided, “ No temporary or final regulation with respect to the definition of a limited partner under Section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998.” *Keatinge, Maxfield & Yearout* believe this moratorium continues congressional misconceptions of the operation of limited partnerships at the expense of providing workable guidance to limited liability companies. They say the impact of the 1997 Regulations on state law limited partnerships is trivial at best both because limited partnerships are largely being supplanted by limited liability companies and because the vast majority of the remaining limited partnerships would not be affected by the regulations.

Given that under all state limited partnership acts a limited partner as such does not have individual liability or the authority to bind the limited partnerships, the only limited partners who would be affected by the 1997 Regulations would be those who spend more than 500 hours in the trade or business of the limited partnership (and then only if the interest held by that limited partner is not identical to the interest of another limited partner who does not spend 500 hours in the business of the partnership) or a limited partner in a service partnership. While there may be some limited partnerships in which all limited partners participate for more than 500 hours, these would be quite exceptional.⁸¹ The other possible application of the 1997 Regulations, the services partner in a services partnership, will only apply in the case of limited partnerships devoted to health, law, engineering, architecture, accounting, actuarial science, or consulting. Even assuming that it is inappropriate from a policy standpoint to treat the consideration given to partners who provide significant services as self-employment income, the number of limited partners who would be subject to these rules would not be significant in comparison with the treatment of all individual members in limited liability companies as having net income from self-employment.⁸²

Regardless of the moratorium on self-employment tax regulations, individual members of LLC’s still must determine how they will treat their distributive share of ordinary income from an LLC. As a result of the moratorium, members and their advisers will have to determine how to account for ordinary income based on the sparse authority available. The only guidance in this area is in the form of private letter rulings holding that a member is a partner and “the members’ distributive shares of income are not excepted from net earnings from self-

⁸⁰ Pub L No. 105-34, 111 Stat 788.

⁸¹ Even Congress recognizes this, the Statement of Managers with respect to the Taxpayer Relief Act describing with the “Passive Loss” provisions of §1221 states: “Limited partners generally do not materially participate in the activities of a partnership.”

⁸² See *Keatinge, Maxfield & Yearout* at p. 28.

employment by Section 1402(a)(13).”⁸³ This would suggest that all members, regardless of the level of their activities or their authority or participation in management, will be subject to self-employment tax. If this is the correct approach, individuals wishing to limit their exposure to self-employment tax would be well advised to use S corporations. An alternative approach would be to assume that all members are “limited partners” and, except to the extent the payments represent guaranteed payments for services, the entire distributive share of ordinary income is excluded from net earnings from self-employment. There is no authority for this approach and several private letter rulings have suggested that, to the contrary, a member is presumed to be a general partner unless expressly made a limited partner by regulations. A third alternative is to assume that the 1997 Regulations as proposed are close to what the final regulations for LLCs will look like, and to draft and report based on a reading of those regulations. The dissension over the regulations by *Keatinge, Maxfield & Yearout* is not that they make too many individuals limited partners, but that they take the benefits of being a limited partner away from some state law limited partners.⁸⁴

Perhaps the most reasonable approach is to assume that regardless of the disagreement between Congress and the Service, the final regulations will resemble or be more generous than the 1997 Regulations. Under Regulation § 1.6662-4(d)(3)(iii), proposed regulations are “substantial authority” for purposes of avoiding the accuracy-related penalty with respect to understatement of income tax.⁸⁵ The taxes imposed on net earnings from self-employment are not “income taxes,” so the substantial authority rules do not apply to the determination of net earnings from self-employment. Nonetheless, in the absence of other authority, the proposed regulations provide some basis for a reporting position. In any case, as in all areas in which there is uncertainty, the ultimate decision should be made by an informed client.

The AICPA Proposal.

On February 19, 1998, the American Institute of Certified Public Accountants submitted a proposal for the taxation of tax partners and sole proprietors. American Institute of Certified Public Accountants Legislative Proposal Regarding Tax on Self-Employment Income. The Proposal Provides:

IN GENERAL The AICPA recognizes the unique nature of limited liability companies (LLCs) and partnerships relative to other forms of business organizations. To the extent that LLCs and partnerships elect or default to partnership status for Federal tax purposes, we believe that general and limited partners and LLC members (hereinafter “partners” who are individual taxpayers

⁸³ Priv. Ltr. Ruls. 9432018,945024, and 9525058.

⁸⁴ See *Keatinge, Maxfield & Yearout* at p. 28.

⁸⁵ IRC § 6662(d)(B).

should be treated in the same manner with respect to determining the amount of their net earnings from self-employment under Subtitle A, Chapter 2 of the Internal Revenue Code. We also believe that, within certain limitations noted below, sole proprietors should be treated in the same manner.

SPECIFIC PROPOSAL

We propose that every partner be required, except as otherwise provided in Section 1402(a), to pay self-employment tax under Section 1401 on the value of the services they perform for or on behalf of the partnership. The valuation of services performed would be based on the general standard of reasonableness which would be determined under either (1) facts and circumstances, or (2) the safe harbor text described below. Partners who receive a reasonable Section 707(c) guaranteed payment for services will not be subject to Section 1401 tax on their distributive share of partnership income under Section 702(a)(8), i.e. they will only be taxed on the guaranteed payment.

SAFE HARBOR TEST

We propose that there be a safe harbor calculation for determining the reasonableness of the value of services performed by partners. This test will provide partners with certainty regarding a fair return on their invested capital which should not be subject to self-employment taxation and an appropriate valuation of their services which is subject to self-employment taxation. If a partner's reported self-employment income varies from the safe harbor amount by more than plus or minus 10%, the amount of self-employment income is subject to reasonableness testing on the basis of facts and circumstances as indicated above. The safe harbor amount is equal to the partner's distributive share of partnership income or loss under Section 702(a)(8) plus Section 707(c) guaranteed payments for services less a reasonable rate of return on the partner's capital account at the beginning of the year (which cannot be less than zero), calculated on the same basis as the reported taxable income of the partnership. The rate of return on the partner's capital account (computed in the same manner as reported by the partnership on Schedule K-1 of Form 1065) will be deemed to be reasonable if the rate used is 150% of the AFR at the end of the partnership's tax year.

DE MINIMIS EXCEPTION

We propose that there be a de minimis exception provided for partners who perform services for the partnership for less than 100 hours during a 12-

Baringer
Advance Tax Issues

month partnership tax year (or for a proportionate number of hours in the case of a short tax year or where a partner joins the partnership during the year). This de minimis rule will provide for administrative simplicity. We recommend that the rule be an affirmative election to enable partners who would like to contribute to the OASDI and HI systems an opportunity to do so. Any income reported as a Section 707(c) guaranteed payment for services will not be available for the election out of the Section 1401 self-employment tax, even when attributable to services of less than 100 hours.

ANTI-ABUSE RULES

We recognize that specific anti-abuse provisions will be required in at least the following areas:

AGGREGATION--Aggregation of partnership interests will be mandatory to prevent partners from using the de minimis exception to avoid paying self-employment taxes. Section 267(e)(3) would be made applicable for this purpose.

COMMONLY-OWNED PARTNERSHIPS--If two partnerships are more than 50% owned by the same persons, then both {sic} partnerships will be aggregated for the purpose of these calculations.

PROVISION FOR SOLE PROPRIETORS--We believe that the same concepts should apply to sole proprietors. Because no requirement currently exists for proprietorships to maintain a capital account or to present a balance sheet for tax purposes, we propose that in order for a proprietor to use the safe harbor method outlined above, they must be required to report a balance sheet (similar to Schedule L on a partnership return) in addition to Schedule C.

The ABA/AICPA Proposal.

On July 6, 1999, the Taxation Section of the American Bar Association recommended an amendment to IRC § 1402 to resolve the treatment of LLCs and other unincorporated business organizations. Under the recommendations:

(a) Net earning from self-employment. The term “net earnings from self-employment” means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in Section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and distributive share of

Baringer
Advance Tax Issues

partnership ordinary income or loss...

(13).

(A) There shall be excluded the distributive share of ~~net any item~~ of income ~~of~~ of a limited partner, as ~~such~~, attributable to capital. ~~other than guaranteed payments described in section 707(e) to that partner for services actually rendered to or on behalf of the partnership to the extent that th~~ those payments are established to be in the nature of remuneration for those services.

(B). Safe harbors, for purposes of subparagraph (a), the following amounts shall be treated as income attributable to capital:

(i). The amount, if any, in excess of what would constitute reasonable compensation for services rendered by such partner to the partnership, or

(ii). An amount equal to a reasonable rate of return on unreturned capital of the partner determined as of the beginning of the taxable year.

(C). Definition. For purposes of subparagraph (B):

(i). Unreturned Capital. The term “unreturned capital” shall mean the excess of the aggregate amount of money and the fair market value as of the date of contribution of other consideration (net of liabilities) contributed by the partner over the aggregate amount of money and the fair market value as of the date of distribution of other consideration (net of liabilities) distributed by the partnership to the partner, increased or decreased for the partner’s distributive share of all reportable items as determined in Section 702. If the partner acquires a partnership interest and the partnership makes an election under Section 754, the partner’s unreturned capital shall take into account appropriate adjustments under Section 743.

(iii). Reasonable rate of return. A reasonable rate of return on unreturned capital shall equal 150% (or such higher rate as is established in regulations) of the highest applicable federal rate, as determined under Section 1274(d)(1), at the beginning of the partnership’s tax year.

(D). The secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph;

The ABA Tax Section recommendation sought to apply consistent rules to all forms of incorporated business organizations and to draw a distinction between income constituting

Baringer
Advance Tax Issues

reasonable compensation and amounts representing a return on capital.⁸⁶ The ABA Taxation Section recommendation was included in H. R. 4137 (The Small Business Tax Modernization Act of 2004) which did not pass.

Until there is a resolution of the issue-either by regulatory action or statute-taxpayers should be able to rely on the 1997 Regulations. On June 10, 2003, Lucy Clark, a national issue specialist in IRS's Examination Specialization Program, suggested that taxpayer's rely on the 1997 Regulations. "If the taxpayer conformed to the latest set of proposed rules, we generally will not challenge what they do or don't do with regard to self-employment taxes."⁸⁷

The JCT Report.

⁸⁶ The recommendation goes on to state:

There are several principles underlying this recommendation that should be incorporated into legislative history. First, income allocable to capital should not be subject to SECA tax (this proposal deals solely with income derived by a person in his or her capacity as a partner in a partnership, although the Section believe the same result should apply in the case of individuals who conduct business as sole proprietors).

Second, the aggregate theory should apply so that income of a sole proprietor from an activity that would otherwise be subject to SECA tax would not escape the tax if the activity is transferred to a partnership (and the individual continues to render services to the partnership), and income that would not be subject to tax if earned by an individual should not become subject to the tax because the activity is transferred to a partnership.

Third, current law recognizes that some of the income of a partner may be attributable to capital and other income attributable to services, and the ability to segregate these types of income should be recognized under the changes to Section 1402. Thus, if a partner is allocated income of a partnership in part because of his or her services and in part because of his or her contribution to capital, the portion of income attributable to capital should not be self-employment income. Under current law, the distinction between these types of income is based on the labels "general partner" and "limited partner." The use of these labels may have been appropriate previously, but the distinction should now be based on the source of a partner's income.

Fourth, the source of capital used in the trade or business should not be relevant. Thus, in determining whether income is attributable to capital or services the same conclusion should result if a partner borrows money and contributes the funds to the partnership or if the partnership borrows the money directly. This conclusion is consistent with and analogous to the operation of Section 752, which treats debt incurred by a partnership as a constructive contribution of money by the partners to the partnership.

Finally, legislative history for the proposed change to Section 1402(a)(13) should note that the determination of whether income is attributable to capital is generally made at the partner level. (Section 49(a)(1)(E) includes a provision of current law where the character is determined at the partner level. Thus, a partner could contribute capital to, and provide no services for, a partnership whose business is a service-oriented business, and this partner would not be subject to the SECA tax on his or her share of partnership income. Similarly, a partner could receive his or her share of partnership income solely as a result of services rendered to a business in which the majority of its income is attributable to capital contributed by other partners, and this partner would be subject to the SECA tax on his or her share of partnership income, unless that income is otherwise excluded from the SECA tax under Section 1402(a).

⁸⁷ Alison Bennett, Taxpayers Can Rely on Proposed Regulations for LLC Self-Employment Taxes, Clark Says, 114 BNA's Daily Tax Report (Friday June 13,2003) Page G-3.

Under the proposal in the JCT Report, the exception for limited partners would be removed and the present-law rule for general partners would be generally applied to any tax partner for determining net earnings from self-employment. Thus, all partners would be subject to self-employment tax on their distributive share (whether or not distributed) of partnership income or loss. As under present law, specified types of income or loss would be excluded from net earnings from self-employment of a partner (other than a partner in a personal service business),⁸⁸ such as rental income, dividends and interest, certain gains, and other items. Under the proposal, in the case of a service partnership, all of the partner's net income from the partnership would be treated as net earnings from self-employment. If, however, any partner (regardless of whether he or she is a general partner, limited partner, or neither a general nor limited partner, such as a limited liability company member) does not materially participate in the trade or business of the partnership, a special rule would provide that only the partner's reasonable compensation from the partnership is treated as net earnings from self-employment. Under the proposal, for purposes of employment tax, an S corporation is treated as a partnership and any shareholders of the S corporation are treated as general partners.⁸⁹

Under New Health Care Law Additional 0.9% Medicare Tax Will Be Imposed after 2012 on Wages and Self-employment Income over Threshold Amounts

Generally effective: Remuneration received, and tax years beginning, after Dec. 31, 2012

(a) FICA Taxes.

The Federal Insurance Contributions Act (FICA) imposes two taxes on employees on wages received with respect to employment. Similar taxes are imposed on the employer for wages paid to their employees.

The Old Age, Survivors and Disability Insurance (OASDI) tax is imposed at a 6.2% rate, on wages up to an annually-adjusted "wage base" (\$106,800 for 2010).

Under pre-Health Care Act law, the Medicare Hospital Insurance (MHI) tax was imposed at a 1.45% rate on all wages, regardless of amount.

Employers must collect the employee FICA tax by withholding it from the employee's wages when paid.

(b) SECA Taxes.

⁸⁸ Similar to IRC § 448(d)(2), a service partnership is a partnership, substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

⁸⁹ See *Keatinge, Maxfield & Yearout* at p. 32.

The Self-Employment Contributions Act (SECA) imposes two taxes on self-employed individuals, the OASDI tax and the MHI tax. These SECA taxes apply to self-employment income, which is generally the taxpayer's "net earnings from self-employment" above a minimum amount for the tax year. There is also an annually-adjusted "ceiling" limitation on the OASDI tax (\$106,800 for 2010), but no ceiling limit on the MHI tax.

The OASDI tax rate is 12.4%. Under pre-Health Care Act law, the MHI tax rate was 2.9% on all of the taxpayer's self-employment income.

(c) Income Tax Deduction for Half of SECA Taxes.

Under pre-Health Care Act law, an income tax deduction was allowed for one-half of the SECA taxes. This deduction is taken above the line, in computing adjusted gross income (AGI).

(d) SECA Tax Deduction for Half of SECA Taxes.

Under pre-Health Care Act law, in computing net earnings from self-employment, in lieu of the above income tax deduction of one-half of the SECA taxes, a taxpayer was allowed a SECA tax deduction under IRC §1402(a)(12) equal to:

- that taxpayer's net earnings from self-employment, as determined before taking the IRC §1402(a)(12) deduction into account, multiplied by
- one-half of the sum of the OASDI tax rate and the MHI tax rate.

The IRC §1402(a)(12) deduction is built into the SECA tax calculation on Schedule SE (Form 1040). It is taken when the taxpayer's trade or business income is multiplied by .9235 on Schedule SE.

The .9235 figure is derived by subtracting 7.65%, which is half of the sum of the OASDI rate of 12.4% and the MHI rate of 2.9% ($50\% \times 15.3\%$), from 1 ($1 - .0765 = .9235$).

(e) The Health Care Act Increases the Employee Portion of the MHI Tax after 2012 by an Additional Tax of 0.9% on Wages Received in Excess of the Applicable Threshold Amount.

Unlike the general 1.45% MHI tax on wages, the additional tax on a joint return is on the combined wages of the employee and the employee's spouse.

The same additional MHI tax applies to the MHI portion of SECA tax on self-employment income.

Baringer
Advance Tax Issues

Thus, an additional tax of 0.9% is imposed on every self-employed individual on self-employment income in excess of the applicable threshold amount. The threshold amount is reduced (but not below zero) by the amount of wages taken into account in determining the taxpayer's FICA tax.

The 0.9% MHI tax on wages and self-employment income is in addition to the 3.8% Medicare contribution tax on net investment income discussed below. Taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes.

(f) Additional FICA tax.

For tax years beginning after Dec. 31, 2012, an additional 0.9% MHI tax will be imposed on taxpayers (other than corporations, estates, or trusts) on wages received with respect to employment in excess of:

- \$250,000 for joint returns (IRC §3101(b)(2)(A)),
- \$125,000 for married taxpayers filing a separate return, i.e., half the joint-return amount (IRC §3101(b)(2)(B) as amended by Reconciliation Act §1402(b)(1)(A)), and
- \$200,000 in all other cases (IRC §3101(b)(2)(C) redesignated by Reconciliation Act §1402(b)(1)(A)).

See (IRC §3101(b)(2) as amended by Health Care Act §9015(a)(1)(D); IRC 3101(b)(2) as amended by Health Care Act §10906(a)).

These threshold amounts, and the ones below for the additional SECA tax, aren't indexed for inflation. Thus, as time goes on, more taxpayers will become subject to these taxes.

This tax will be in addition to the regular MHI tax rate of 1.45% of wages received by employees with respect to employment. (IRC §3101(b)(1) as amended by Health Care Act §9015(a)(1)).

Thus, the MHI tax rate will be:

- 1.45% on the first \$200,000 of wages (\$125,000 on a separate return, \$250,000 of combined wages on a joint return); and
- 2.35% (1.45% + 0.9%) on wages in excess of \$200,000 (\$125,000 on a separate return, \$250,000 of combined wages on a joint return).

This change doesn't affect the MHI tax imposed on employers.

Example 1: A single taxpayer earns wages of \$500,000 for 2013. Taxpayer pays MHI tax of \$2,900 on the first \$200,000 of wages ($\$200,000 \times 1.45\%$) and \$7,050 on the excess of his wages over \$200,000 ($\$300,000 \times 2.35\%$), for a total MHI tax of \$9,950.

Example 2: For 2013, H and W file a joint return. H earns wages of \$125,000 and W earns wages of \$175,000. H and W pay MHI tax of \$3,625 ($\$250,000 \times 1.45\%$) on their first \$250,000 of wages and \$1,175 on the excess of their combined wages over \$250,000 ($\$50,000 \times 2.35\%$), for a total MHI tax of \$4,800.

(g) Employer's Obligation to Withhold.

The employer is required to withhold the additional 0.9% MHI tax on wages. The employer is liable for the tax that it fails to withhold from wages or to collect from the employee (where the employer fails to withhold).

However, an employer's obligation to withhold the additional 0.9% MHI tax applies only to wages in excess of \$200,000 that the employee receives from the employer. The employer may disregard the amount of wages received by the employee's spouse. (IRC §3102(f)(1) as amended by Health Care Act §9015(a)(2)). The Committee Report adds that the employer must disregard the spouse's wages.

Thus, the employer is only required to withhold the additional 0.9% MHI tax on wages in excess of \$200,000 for the year, even though the tax may apply to a portion of the employee's wages at or below \$200,000, if the employee's spouse also has wages for the year, they are filing a joint return, and their total combined wages for the year exceed \$250,000.

Example 3: For 2013, H has wages of \$250,000, and W has wages of \$100,000. H's employer must withhold the additional 0.9% MHI tax on the \$50,000 of H's wages in excess of \$200,000. W's employer isn't required to withhold any portion of the additional 0.9% MHI tax, even though H and W's combined wages are over the \$250,000 threshold.

Couples in this situation may have to make estimated tax payments to cover the additional 0.9% MHI tax, because the amounts withheld by their employers won't be sufficient. See below under "Effect on employee's estimated tax."

The employer won't be liable for any additional 0.9% MHI tax that it fails to withhold and that

Baringer
Advance Tax Issues

the employee later pays, but will be liable for any penalties resulting from its failure to withhold.

(h) Employee's Liability for Additional Tax.

The employee will be liable for the additional 0.9% MHI tax to the extent it isn't deducted by the employer. (IRC §3102(f)(2)). In contrast, employees generally have no direct liability for the employee portion of the general 1.45% MHI tax.

(i) Effect on Employee's Estimated Tax.

The amount of the additional 0.9% MHI tax not withheld by an employer must be taken into account in determining a taxpayer's estimated tax liability. Generally, taxpayers must make four quarterly estimated tax payments based on the "required annual payment," which is the lower of 90% of the tax shown on the current year's return or 100% of the tax shown on the previous year's return. For this purpose, the term "tax" means income tax plus SECA tax, minus certain credits. The additional 0.9% MHI tax, to the extent not withheld, is treated as SECA tax for purposes of determining the taxpayer's estimated tax liability. (IRC §6654(m) as amended by Reconciliation Act §1402(b)(2)).

Estimated tax payments may have to be made by married couples who have insufficient withholding

(j) Additional SECA Tax.

For tax years beginning after Dec. 31, 2012, an additional 0.9% MHI tax will be imposed on taxpayers (other than corporations, estates, or trusts) on self-employment income for the tax year in excess of:

- \$250,000 for joint returns (IRC §1401(b)(2)(A)(I)),
- \$125,000 for married taxpayers filing a separate return, i.e., half the joint-return amount (IRC §1401(b)(2)(A)(ii) as amended by Reconciliation Act §1402(b)(1)(B)(i)), and
- \$200,000 in all other cases. (IRC §1401(b)(2)(A)(iii) redesignated by Reconciliation Act §1402(b)(1)(B)(i)).

Thus, the tax rate for the MHI portion of the SECA taxes will be:

- 2.9% on the first \$200,000 of self-employment income (\$125,000 on a separate return, \$250,000 of combined self-employment income on a joint return); and

· 3.8% (2.9% + 0.9%) on self-employment income in excess of \$200,000 (\$125,000 on a separate return, \$250,000 of combined self-employment income on a joint return).

Example 4: A single taxpayer has self-employment income of \$500,000 for 2013. Taxpayer pays the MHI portion of the SECA taxes of \$5,800 on the first \$200,000 of self-employment income ($\$200,000 \times 2.9\%$) and \$11,400 on the excess of his self-employment income over \$200,000 ($\$300,000 \times 3.8\%$), for a total MHI tax of \$17,200.

Example 5: For 2013, H and W file a joint return. H has self-employment income of \$125,000 and W has self-employment income of \$175,000. H and W pay the MHI portion of the SECA taxes of \$7,250 ($\$250,000 \times 2.9\%$) on the first \$250,000 of their combined self-employment income. They also pay MHI tax of \$1,900 on the excess of their combined self-employment income over \$250,000 ($\$50,000 \times 3.8\%$), for a total MHI tax of \$9,150.

The above thresholds will be reduced (but not below zero) by the amount of wages taken into account in determining the additional 0.9% MHI tax on wages under IRC §3121(b)(2) (IRC §1401(b)(2)(B) as amended by Reconciliation Act §1402(b)(1)(B)(ii)), i.e., by the amount of wages taken into account in determining the taxpayer's FICA tax.

The reference to IRC §3121(b)(2) appears to be a drafting error. IRC 3121(b)(2) is an unrelated FICA definition. The more likely reference would be to IRC 3101(b)(2), which imposes the additional 0.9% MHI tax on wages.

(k) Income Tax Deduction for One-half of SECA Taxes.

The income tax deduction for one-half of SECA taxes will be computed without regard to the additional 0.9% SECA tax. (IRC §164(f) as amended by Health Care Act §9015(b)(2)(A)).

Thus, although taxpayers will pay the MHI portion of SECA tax at a 3.8% rate on the excess over the applicable threshold, the income tax deduction for one-half of SECA taxes will be computed based on a 2.9% rate. The additional 0.9% tax won't generate an income tax deduction.

(l) SECA Tax Deduction for One-half of SECA Taxes.

The IRC 1402(a)(12) deduction from net earnings from self-employment will be computed using half the sum of the OASDI tax rate and the regular MHI tax rate (i.e., 7.65%), without regard to

Baringer
Advance Tax Issues

the additional 0.9% SECA tax. (IRC §1402(a)(12)(B) as amended by Health Care Act §9015(b)(2)(B)).

Thus, the additional 0.9% tax won't generate a SECA tax deduction.

Effective: Remuneration received, and tax years beginning, after Dec. 31, 2012.

New Health Care Laws Impose New 3.8% Medicare Contribution Tax after 2012 on Net Investment Income of Individuals, Estates, and Trusts.

Generally effective: Tax years beginning after Dec. 31, 2012

(a) Medicare Contribution Tax for Individuals.

The Reconciliation Act imposes a new unearned income Medicare contribution tax on individuals, estates, and trusts.

The tax is generally levied on income from interest, dividends, annuities, royalties, rents, and capital gains. For individuals, the tax is 3.8% of the lesser of (a) net investment income or (b) the excess of modified adjusted gross income (MAGI) over the applicable threshold amount.

Net investment income is investment income reduced by the deductions properly allocable to such income. MAGI is adjusted gross income (AGI) increased by the amount excluded from income as foreign earned income, net of the deductions and exclusions disallowed with respect to the foreign earned income.

The threshold amount is \$250,000 for joint returns or surviving spouses, \$125,000 for separate returns, and \$200,000 in other cases.

Only individuals with MAGI above the applicable threshold amount will be subject to the tax.

Example 1: For 2013, a single taxpayer has net investment income of \$50,000 and MAGI of \$180,000. The taxpayer won't be liable for the Medicare contribution tax, because his MAGI (\$180,000) doesn't exceed his threshold amount (\$200,000).

Example 2: For 2013, a single taxpayer has net investment income of \$100,000 and MAGI of \$220,000. The taxpayer would pay a Medicare contribution tax only on the \$20,000 amount by which his MAGI exceeds his threshold amount of \$200,000, because that is less than his net investment income of \$100,000. Thus, taxpayer's Medicare contribution tax would be \$760 (\$20,000 ×

3.8%).

An individual will pay the 3.8% tax on the full amount of his net investment income if his MAGI exceeds his threshold amount by at least the amount of the net investment income.

Example 3: Assume that the taxpayer in Example 2 had MAGI of \$300,000. Because the taxpayer's MAGI exceeds his threshold amount by \$100,000, he would pay a Medicare contribution tax on his full \$100,000 of net investment income. Thus, taxpayer's Medicare contribution tax would be \$3,800 ($\$100,000 \times 3.8\%$).

The Medicare contribution tax is in addition to the 0.9% MHI tax on wages and on self-employment income in excess of threshold amounts. Taxpayers who have both high wages or self-employment income and high investment income may be hit with both taxes.

Example 4: For 2013, a single taxpayer has net investment income of \$100,000, wages of \$300,000, and MAGI of \$375,000. In addition to paying a Medicare contribution tax of \$3,800, as explained in Example 3, the taxpayer would also pay an additional MHI (Medicare) tax of \$900 ($\$100,000 \times 0.9\%$) on his wages in excess of \$200,000.

(b) Medicare Contribution Tax for Trusts & Estates.

For estates and trusts, the tax is 3.8% of the lesser of (a) undistributed net investment income or (b) the excess of AGI over the dollar amount at which the highest estate and trust income tax bracket begins.

The Medicare contribution tax provisions comprise the new Chapter 2A of Subtitle A of the Internal Revenue Code. (Reconciliation Act §1402(a)(1)).

(c) Calculation of the Medicare Contribution Tax for Individuals.

Individuals are subject to a Medicare contribution tax for each tax year equal to 3.8% of the lesser of:

(1) net investment income (defined below) for the tax year, or

(2) the excess (if any) of:

· the MAGI for the tax year (defined below) (IRC §1411(a)(1)(B)(i)), over

- the threshold amount (defined below) (IRC §1411(a)(1)(B)(ii)).

See (IRC §1411(a) as added by Reconciliation Act §1402(a)(1)).

The Medicare contribution tax is in addition to any other tax imposed by Subtitle A of the Code, relating to income taxes. (IRC §1411(a)(1)). Thus, the Medicare contribution tax isn't deductible in computing income taxes.

The Medicare contribution tax doesn't apply to nonresident aliens (NRAs). (IRC §1411(e)(1)).

Thus, it applies to U.S. citizens and resident aliens.

(d) “Net Investment Income” Defined.

For purposes of the Medicare contribution tax (IRC §1411(c)) , “net investment income” means the excess, if any, of:

(1) the sum of (IRC §1411(c)(1)(A)):

- gross income from interest, dividends, annuities, royalties, and rents, unless those items are derived in the ordinary course of a trade or business to which the Medicare contribution tax doesn't apply (see below) (IRC §1411(c)(1)(A)(i)),
- other gross income derived from a trade or business to which the Medicare contribution tax applies (below) (IRC §1411(c)(1)(A)(ii)), and
- net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the Medicare contribution tax doesn't apply (IRC §1411(c)(1)(A)(iii)), over

(2) the allowable deductions that are properly allocable to that gross income or net gain. (IRC §1411(c)(1)(B)).

Gross income doesn't include items, such as tax-exempt bond interest, veterans' benefits, and

excluded gain from the sale of a principal residence, that are excluded from gross income for income tax purposes.

(e) Trades and Businesses to Which Tax Applies.

The Medicare contribution tax applies to a trade or business if it is (IRC §1411(c)(2)):

- a passive activity of the taxpayer, within the meaning of IRC §469 (IRC §1411(c)(2)(A)), or
- a trade or business of trading in financial instruments or commodities, as defined in IRC §475(e)(2) (IRC §1411(c)(2)(B)).

The Medicare contribution tax doesn't apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.

Thus, for a taxpayer that doesn't engage in a passive activity or a financial instrument or commodities trading business, "net investment income" will include non-business income from interest, dividends, annuities, royalties, rents, and capital gains, minus the allocable deductions.

(f) Business Income Won't Be Included.

For a taxpayer that does engage in a passive activity or a financial instrument or commodities trading business, "net investment income" will include the above items, plus the gross income (minus allocable deductions) from the passive activity or trading business.

(g) Income on Investment of Working Capital Subject to Tax.

For purposes of the definition of "net investment income," a rule applies that is similar to the rule of IRC §469(e)(1)(B), which treats income, gain, or loss attributable to an investment of working capital as not derived in the ordinary course of a trade or business. (IRC §1411(c)(3)).

Thus, income, gain, or loss on invested working capital isn't treated as derived from a trade or business.

As a result, those items will be subject to the new Medicare contribution tax.

(h) Exception for Certain Active Interests in Partnerships and S Corporations.

Gain from a disposition of an interest in a partnership or S corporation is taken into account as net investment income only to the extent of the net gain that the transferor would take into account if the partnership or S corporation had sold all its property for fair market value immediately before the disposition. (IRC §1411(c)(4)(A)).

A similar rule applies to a loss from a disposition of an interest in a partnership or S corporation. (IRC §1411(c)(4)(B)).

Thus, only net gain or loss attributable to property held by the entity that isn't property attributable to an active trade or business is taken into account. For this purpose, a business of trading financial instruments or commodities isn't treated as an active trade or business.

(i) Qualified Plan Distributions.

Qualified retirement plan distributions aren't included in investment income. Specifically, pursuant to IRC §1411(c)(5), net investment income doesn't include any distribution from a plan or arrangement described in:

- IRC §401(a) (qualified pension, profit-sharing, and stock bonus plans);
- IRC §403(a) (qualified annuity plans);
- IRC §403(b) (annuities for employees of tax-exempt organizations or public schools);
- IRC §408 (individual retirement accounts-IRAs);
- IRC §408A (Roth IRAs);
- IRC §457(b) (deferred compensation plans of state and local governments and tax-exempt organizations).

(j) Amounts Subject to SECA Taxes.

Investment income doesn't include amounts subject to SECA taxes. Specifically, net investment income doesn't include any item taken into account in determining self-employment income for the tax year, if that item is subject to the MHI portion of SECA taxes under IRC §1401(b). See (IRC §1411(c)(6)).

(k) "MAGI" Defined.

Under IRC §1411(d), for purposes of the Medicare contribution tax, "MAGI" means AGI increased by the excess of:

- (1) the amount excluded from gross income under the IRC

§911(a)(1) foreign earned income exclusion (IRC §1411(d)(1)),
over

(2) the amount of any deductions (if taken into account in computing AGI) or exclusions that are disallowed under IRC §911(d)(6) with respect to the amounts in (1), above. (See IRC §1411(d)(2)).

(I) “Threshold Amount” Defined.

Pursuant to IRC §1411(b), for purposes of the Medicare contribution tax, “threshold amount” means:

- for joint return filers and surviving spouses - \$250,000. (IRC §1411(b)(1)).
- for married taxpayers filing a separate return - half of the dollar amount applicable to joint return filers and surviving spouses (IRC §1411(b)(2)), i.e., \$125,000.
- for all other taxpayers - \$200,000. (IRC §1411(b)(3)).

These threshold amounts aren’t indexed for inflation. Thus, as time goes on, more taxpayers will become subject to the Medicare contribution tax.

G. Transfer of Appreciated Property to the LLC

An important exception to the general nonrecognition rules regarding contributions to and distributions from partnerships relates to contributions to a partnership that are closely linked to distributions. These are directed at eliminating or limiting the ability of partners in a partnership to engage in what are referred to as “mixing bowl” transactions. Because the IRC generally allows for nonrecognition of gain or loss on contributions to a partnership and on distributions from a partnership, partners used to be able to use partnership tax law to avoid tax on what amounts to a sale of property from one partner to the other where, among other property and cash contributed to a partnership one partner contributes Blackacre to the partnership and it is ultimately distributed out to the other partner. There are three facets to this exception: (1) the “disguised sale” rules in IRC §707(a), under which contributions may be recharacterized, in whole or in part, as sales, if the contributor receives distributions from the partnership that are, in substance, consideration for the contributed property; (2) IRC §704(c)(1)(B), which generally requires a partner who contributes property to recognize gain or loss if the contributed property is distributed to another partner within seven years of its contribution; and (3) IRC §737, which may cause a contributor of appreciated property to

Baringer
Advance Tax Issues

recognize gain upon the receipt of distributions of other property from the partnership within seven years after the contribution. §704(c)(1)(A) also requires that income, gain, loss, and deductions with respect to property contributed to the partnership by a partner must be allocated and shared among the partners so as to take account of the variation between the basis for the property to the partnership and its fair market value at the time of contribution. Essentially, the regulations require that this pre-contribution or loss must be allocated to the contributing partner whenever the same is recognized by the partnership.

Like contributions to partnerships, partnership distributions generally do not give rise to the recognition of gain or loss. The distributee generally takes a carryover basis in the property, and his basis in his partnership interest is reduced by a like amount. There are exceptions to these general rules, however. These are designed to take into account the possibility that the amount of cash and the basis of property distributed may exceed the distributee's basis in his partnership interest or, in connection with the liquidation of a partnership interest, may be less than the distributee's basis in his interest. Under these circumstances, the distributee recognizes gain to the extent he receives cash in excess of his basis in his partnership interest. [IRC §731(c)(1)]. For purposes of this gain recognition rule, "marketable securities" are valued at market and treated as the equivalent of cash. [IRC §731(c)]. The distributee recognizes loss in the event he receives solely cash, "unrealized receivables," and "inventory" the aggregate basis of which is less than the basis of his liquidated partnership interest. [IRC §731(a)(2)]. The basis of distributed property is generally equal to the partnership's basis, but, in the aggregate, is limited to the basis of the distributee's partnership interest and, in the context of a liquidating distribution, is increased (with respect to property other than "unrealized receivables" and "inventory") to equal the basis of the liquidated interest.

The basis of remaining partnership assets is generally not affected by distributions to partners. [IRC §734(a)]. However, if the partnership so elects, basis adjustments may be made in connection with distributions in which the distributee recognizes either gain or loss or does not take carryover basis for distributed property under one of the exceptions to the general nonrecognition and carryover basis rules noted previously. [IRC §734(b)].

Special rules are applicable if the partnership owns unrealized receivables or inventory. If a distribution changes the distributee's interest in unrealized receivables or substantially appreciated inventory, a portion of the distributed property may be treated as received in a taxable exchange for the distributee's interest in other partnership assets. [IRC §751(b)]. Moreover, under IRC §735(a), the character of unrealized receivables and inventory distributed to a partner is preserved (indefinitely with respect to unrealized receivables, and for five years with respect to inventory) in the hands of the distributee. These rules are designed to prevent the use of distributions to shift partnership ordinary income among the partners or convert partnership ordinary income to capital gain.

H. Death or Retirement of a Member and Tax Alternatives

Baringer
Advance Tax Issues

Special rules are provided for payments by a partnership to a retiring partner or the successor of a deceased partner. Under IRC §736, the portion of such payments attributable to the partner's interest in partnership property is subject to the distribution rules outlined throughout these materials, and the remainder is treated as either a distributive share of partnership income or a guaranteed payment to the distributee.[IRC §736(a)]. Certain amounts received by the successor of a deceased partner may constitute income in respect of a decedent for purposes of IRC §691.

When a partner retires or dies, amounts paid by the partnership to the retiring partner or to his estate (or other successor) in liquidation of the partner's interest in the entity, must be allocated between (a) payments in exchange for the interest in the assets of the partnership and (b) other payments. §736 covers the tax treatment of these payments, but it does not apply if an estate, heir, or other successor continues as a partner. Local law determines when a successor continues as a partner and also when a retiring partner ceases to be a partner; but for tax purposes both continue as partners until the partnership is completely liquidated. Reg. §1.736-(a)(1) and Reg. §1.736-1(a)(6).

If less than the partner's entire interest in the partnership is to be liquidated, payments are current distributions. If remaining partners or outsiders pay for the partner's interest, IRC §741 controls, with different tax consequences.

To distinguish the portion of §736 payments that are in exchange for a partner's interest in partnership property (and treated as a distribution) from the portion treated as a distributive share or guaranteed payment, the following rules apply: If a fixed amount is to be received over several years, the portion of each payment treated as a distribution bears the same ratio to the total fixed agreed payments for the year (whether actually received or not) as the total fixed agreed payments for the interest in property bear to the fixed agreed payments. The remainder, if any, of the amount received in the year is a distributive share or guaranteed payment. If the total received is less than the amount considered as a distribution, then any unused portion is carried over and added to the portion treated as a distribution in later years.

Example. A has retired from the partnership and is entitled to \$50,000 for 10 years for his interest in partnership property. He receives only \$25,000 in year 1, but in year 2 he receives \$100,000. Of this \$100,000, a total of \$75,000 (\$50,000 plus \$25,000) is a distribution under §736(b) and \$25,000 is a guaranteed payment or distributive share.

If the payments received aren't fixed in amount, they are first treated as payments in exchange for the partnership interest to the extent of the value of the interest. The remainder represents a guaranteed payment or the distributive share.

The allocation of annual payments may be made in any way agreed on by the remaining partners and the withdrawing partner or his or her successor in interest. But in that case, the total amount allocated to the payment for the property interest can't exceed the fair market value of the property at the date of death or retirement.

Payments to a withdrawing partner (i.e. a retiring partner or decedent's successor) for his interest in partnership assets are treated as distributions by the partnership and not as a distributive share or guaranteed payment. Reg. §1.736-1(b). Liquidation payments made for goodwill and unrealized receivables are generally treated as made in exchange for the partner's interest in the partner's interest in partnership property, but a special rule applies to general partners in service partnerships.

Payments for interests in substantially appreciated inventory items result in ordinary income and are subject to the rules under §751. A partner's death does not change the partnership's basis in these items.

The IRS usually accepts the partners' agreed values for the withdrawing partner's interest in assets. Payments in exchange for a withdrawing partner's interest in assets first reduce that partner's basis; any excess is capital gain, recognized to the extent provided in §731, and when applicable, §751. When payment is made in fixed installments over several years, no gain is recognized until capital is recovered, unless the withdrawing partner elects to treat each payment as part gain and part return of capital under Reg. §1.736-1(b)(6). Payments in exchange for a withdrawing partner's interest in assets do not reduce the remaining partners' distributive shares.

IRC §736 gives partners alternative ways to handle payments to a retiring member. The following examples illustrate some of these.

Example 1. The ABC partnership pays retired partner C \$15,000 per year for 10 years for his interest in the partnership. The basis of C's interest is \$90,000. Of the \$150,000 C will receive over the 10 years, \$90,000 will go in reduction of his basis and the remaining \$60,000 will be capital gain.

Example 2. Assume that in example 1, C's interest in partnership property included an interest worth \$50,000 in appreciated inventory. Assume also that \$15,000 of C's basis of \$90,000 is attributable to this inventory. Then, of the \$150,000 C will receive, \$90,000 goes in reduction of his basis, \$35,000 (\$50,000 - \$15,000) is ordinary income, and \$25,000 (\$100,000 - \$75,000) is capital gain.

Example 3. Each year AB partnership pays retired partner C 10% of partnership net income. Payments are taxed to C as if he still had a 10% distributive share of the partnership income, loss, deductions and credits.

Example 4. If, in Example 3, the payments were \$100 per week rather than 10% of partnership net income, the payments received by C are ordinary income to him, and are deductible by the partnership as salary (guaranteed payments).

Example 5. ABC is a personal service partnership. When A retires, the partnership's balance sheet is as follows:

<u>Assets</u>			<u>Liabilities & Capital</u>		
	<u>Basis</u>	<u>Value</u>		<u>Basis</u>	<u>Value</u>
Cash	\$13,000	\$13,000	Liabilities	\$3,000	\$3,000
Land	<u>\$20,000</u>	<u>\$23,000</u>	Capital		
	\$33,000	\$36,000			
			A	\$10,000	\$11,000
			B	\$10,000	\$11,000
			C	<u>\$10,000</u>	<u>\$11,000</u>
				\$30,000	\$36,000

It is agreed that A's capital interest is valued at \$12,000 (1/3 of \$36,000) and that A will receive \$5,000 per year for 3 years after his retirement. The first \$5,000, however, will include A's share of the liabilities (\$1,000) assumed by B and C.

Tax Treatment of A: The basis of A's interest is \$11,000 (\$10,000 investment plus \$1,000, his share of debts). Of the \$15,000 A is to receive, only \$12,000 is in payment of his interest in the partnership property. The remainder is ordinary income. Thus, A will have \$1,000 capital gain (\$12,000 - 11,000), and \$3,000 ordinary income. A may report the \$1,000 capital gain at the time he receives his last payment, or he may elect to allocate the gain over the 3 years. If he elects to allocate, he may report \$333 capital gain and \$1,000 ordinary income each year (1/3 of the total amounts of capital gain and ordinary income, respectively). The remainder is a return of capital.

Tax Treatment of Remaining Partners: The partnership cannot deduct A's \$1,000 capital gain since the amount represents a purchase of A's capital interest by the partnership. The partnership may deduct A's \$3,000 ordinary income.

Example 6. Assume the same facts as in Example 5 except that the agreement provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. In this case, all payments received by A up to \$12,000 are treated as payments for A's interest in partnership property. His gain of \$1,000 is taxed only after he has received his full basis. Any payment in excess of \$12,000 is treated as a distributive share of partnership income to A.

Until the provisions of §736 were restrictively amended in 1993, §736 afforded partners unparalleled flexibility in structuring the tax consequences of liquidating payments. The pre-1993 version of §736 allowed partners to elect to treat liquidation payments for a partner's interest in the partnership goodwill as either (1) deductible by the partnership and ordinary income to the retiring partner, or (2) nondeductible by the partnership and capital gains to the retiring partner. Further, all distributions in liquidation of a partner's interest in partnership unrealized receivables (as defined in §751(c)), including §1245 and other recapture items as well as traditional receivables and work-in-process, produced deductions for the partnership and ordinary income to other retiring partners. While it is no longer possible for a partnership to deduct §736 payments for such capital assets as the value of machinery subject to §1245 recapture or (except in limited circumstances) goodwill, §736 still provides considerable flexibility to partners to determine the tax consequences of partner retirements.

Initially, the partners may choose either to liquidate the partner's interest under §736 or to effect essentially the same economic result by means of a purchase of the retiring partner's interest proportionately by the continuing partners. Although the economic consequences of a liquidation and a pro rata purchase of a retiring partner's interest by continuing partners may be identical, the tax consequences of the two alternatives may differ considerably. Even within the confines of the §736 liquidation procedure, partners have considerable flexibility in allocating tax benefits and burdens between the partnership and the retiring partner. Thus, the partners have substantial latitude in determining what portion of total liquidating payments is attributable to §736(b) property and what portion is taxable under §736(a). In addition, if the liquidation is effected through a series of payments, the partners may by agreement apportion each installment between §736(a) and §736(b) amounts. Finally, the partners may determine whether payments for a retiring general partner's interest in the goodwill of a service partnership are taxed as §736(b) property payments or as §736(a) payments.

I. Federal Income Tax Techniques Involved in the Use of Disregarded Entities (Single Member LLCs) in Mergers, Acquisitions and Dispositions

Recently issued regulations in the corporate tax arena have clarified the application of some of the tax free corporate reorganization rules in corporate reorganizations and acquisitions and thus increased the utility of the LLC in the acquisition context. As a result, it is now considered to be easier to use the LLC in corporate reorganizations in its role as a disregarded entity. Recently issued regulations in the partnership arena under IRC § 708 now allow acquisitions of tax partnerships through the use of the LLC.

a. Corporate Acquisitions

Corporations are free to combine with other corporations tax free under the various reorganization rules of IRC § 368, provided the technical requirements of the Code and regulations are met. With advent of the "disregarded entity" under the Check-the-Box regulations in 1997, the mergers and acquisitions world was elated with the possibilities which it

Baringer
Advance Tax Issues

presented as a tool to accomplish reorganizations and conversions of corporate entities to LLCs for various purposes such as avoiding the corporate franchise tax. On May 16, 2000 the IRS dropped a bombshell on this area with the issuance of proposed regulations (the “Initial Proposed Regs”) which provided that a corporation with a wholly owned LLC could not use that LLC to acquire the assets of another corporation in a tax-free Code § 368(a)(1)(A) statutory merger. Although the LLC could be used to acquire assets in a Code § 368(a)(1)(C) reorganization, the “A” reorganization is generally preferred over the “C” reorganization because there are fewer pitfalls in the A reorganization rules.⁹⁰

On November 15, 2001, the Service issued revised proposed regulations which replaced the Initial Proposed Regs.⁹¹ These regulations have now become final regulations (the “Final Regulations”) and allow combinations using LLCs that are wholly owned by a corporation to qualify for the “A” reorganization treatment under the more easily satisfied rules of IRC § 368(a)(1)(A).⁹²

There are a number of advantages to using a wholly owned LLC in an acquisition structured to qualify as an “A” reorganization. The use of the wholly owned LLC enables the acquiring corporation to segregate its assets from the liabilities of the target corporation. Using a subsidiary LLC to effect a merger may allow the acquiring corporation to consummate the transaction without shareholder approval, which would be required if the corporation merged with the target directly. Because the disregarded entity single member LLC is treated as a division of a corporate single member, a corporation also may use a wholly owned LLC to avoid multiple returns and to avoid application of the complex consolidated return rules.

Example 1. A, a C corporation, is the sole member of B, an LLC which has not elected to be treated as an association taxable as a corporation. A wishes to

⁹⁰ 65 F.R. 31115. See Rizzi, “Mergers Into Tax Nothings: The Service Sees the Light,” 29 *Corp.Tax'n* 23 (March/April 2002); Bailine, “When is an ‘A’ Not an ‘A’? When It’s a Fish,” 28 *J.Corp.Tax'n* 30 (March/April 2001); “AICPA Suggests Change to Proposed Regs on Mergers Involving Disregarded Entities,” *Tax Notes Today* 240-13 (Dec. 13, 2000); “Members of ABA Tax Section Suggest Changes to Proposed Regs on Mergers Involving Disregarded Entities,” *Tax Notes Today* 208-19 (Oct. 26, 2000); Bank, “Taxing Divisive and Disregarded Mergers,” 34 *Ga.L.Rev.* 1523 (Summer 2000).

⁹¹ 66 F.R. 57400.

⁹² See Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts* (New York, NY: Panel Publishers, 2001) at ¶ 801.2. A “C” reorganization will permit only a limited use of consideration other than stock under IRC § 368(a)(2)(B), which may give rise to concerns about disguised consideration. The “A reorganization does not create the same issues. In addition, a corporation must acquire “substantially all” of the assets of the acquired corporation to qualify for a “C” reorganization. The preamble to the proposed regulations indicates a more lenient standard for mergers using disregarded entities, stating that “the IRS and Treasury do not intend for the requirement that all of the assets of one or more transferor units be transferred in the statutory merger or consolidation to be interpreted in the same manner as the ‘substantially all’ requirement of [IRC §§] 368(a)(1)(C), 368(a)(1)(D), 368(a)(2)(D), and 368(a)(2)(E).” 66 F.R. 57400.

acquire the business of a target corporation (“T”).

The first example of a disregarded entity in the Final Regulations is a single member LLC that does not elect to be classified as an association taxable as a corporation for federal tax purposes, i.e. a disregarded entity. Under the Final Regulations, a “combining entity” is defined as a business entity that is a corporation and that is not a disregarded entity.⁹³ Under this definition, A and T are “combining entities.”

For federal tax purposes, each “combining unit” consists of: (1) a combining entity; and (2) all of the disregarded entities, the assets of which are treated as owned by the combining entity. In this example, B and A are, together, a “combining unit.” Likewise, T is a combining unit. The combining unit that transfers its assets and liabilities to another combining unit is the “transferor unit,” while the combining unit to which those assets and liabilities are transferred is the “transferee unit.” In the example, the combining unit, composed of B and A, will be the “transferee unit.” The combining unit consisting of T will be the “transferor unit.”

To qualify as a statutory merger under IRC § 368(a)(1)(A) the Final Regulations, require two simultaneous events. First, all assets and liabilities of each member of one or more transferor units must become the assets and liabilities of one or more transferee units.⁹⁴ Second, the combining entity of each transferor unit must cease its separate legal existence for all purposes. *See* Prop. Reg. § 1.368-2(b)(1)(ii)(B). Both requirements will be met if T merges into B, under state law, with B surviving and the shareholders of T receiving the stock of A. Louisiana law allows for the merger of a corporation into an LLC under La.R.S. 12:1357. The assets and liabilities of the transferor unit, T, become the assets and liabilities of B, a member of the transferee unit. Simultaneously, T ceases its separate legal existence. For tax purposes, B is disregarded and T has merged into A, which is a traditional IRC § 368(a)(1)(A) reorganization.⁹⁵

⁹³ Prop. Reg. § 1.368-2(b)(1)(i)(B). Importantly, the Final Regulations require that the combining entity of the transferor unit, the combining entity of the transferee unit, each business entity through which the combining entity of the transferee unit holds its interests in the disregarded entities, and all of the disregarded entities be organized under the laws of the United States or a state or the District of Columbia. Prop. Reg. § 1.368-2(b)(1)(iii).

⁹⁴ Prop. Reg. § 1.368-2(b)(1)(ii)(A). According to the preamble to the Final Regulations this requirement is not intended to be interpreted in the same manner as the “substantially all” requirement of IRC §§ 368(a)(1)(C), 368(a)(1)(D), 368(a)(2)(D), and 368(a)(2)(E). Instead, the preamble states that “the IRS and Treasury do intend this requirement to ensure that divisive transactions do not qualify as statutory mergers or consolidations under IRC § 368(a)(1)(A),” *citing* Rev. Rul. 2000-5, 2000-5 I.R.B. 436 (“mergers” in which a target corporation does not go out of existence or is absorbed into two or more acquiring corporations does not qualify under IRC § 368(a)(1)(A)). 66 F.R. 57400. Nonetheless, the proposed regulations recognize that certain assets of the transferor unit may be distributed and that certain liabilities may be satisfied or discharged in the transaction. These assets and liabilities are excepted from this transfer requirement, resulting in the more lenient standard of the proposed regulations, compared to the “substantially all” requirement imposed on other types of reorganizations.

⁹⁵ While the transaction might be covered under IRC § 368(a)(1)(c), coverage under the Final Regulations allows the parties to avoid the more stringent requirements of this provision.

Example 2: In a variation on the facts from Example 1, B merges into T, with C receiving voting stock of T. Does this transaction qualify as an “A” reorganization?

Now, T becomes the transferee unit, and the combining unit composed of B and A becomes the transferor unit. Neither of the requirements of the Final Regulations is satisfied. Here, the transferor unit has not transferred all of its assets and liabilities to the transferee unit (none of A's assets and liabilities that are held outside of B have been transferred) and, while B has ceased its existence for all purposes, B does not qualify as a combining entity. *See* Prop. Reg. § 1.368-2(b)(1)(iv) Example 5. While the transaction may qualify for tax-free treatment as a “B” reorganization under IRC § 368(a)(1)(B), it will not qualify if all of the requirements for that type of reorganization were not met. For instance, under the “B” reorganization rules, T's shareholders cannot receive any consideration other than the voting stock of A or its parent. Rev. Rul. 2000-5, *supra*, limits the availability of “A” reorganization treatment in divisive transactions.

Example 3: In another variation on the facts of Example 1, the shareholders of T take the stock of B in consideration for the merger of T into B. As a result, B is no longer treated as a disregarded entity. Assume also that B files an election under the Check-the-Box regulations to be taxed as a corporation. (Unless the election is filed, B would become a partnership with possible disastrous tax consequences, *i.e.*, liquidation with C corp gain recognition and second layer of tax to members..

Does the transaction qualify as an “A” reorganization. Here, the assets and liabilities of T are being transferred to an entity that is separate from the possible transferee unit, A. Therefore, first requirement of the Final Regulations is not satisfied, *i.e.*, all assets and liabilities of each member of one or more transferor units have not become the assets and liabilities of one or more transferee units.

Example 4: . A, which wholly owns B (the disregarded entity), is owned by a corporation that is ineligible to be a Subchapter S corporation (“P”). Assume further that P owns: (1) at least 80 percent of the total combined voting power of all classes of stock entitled to vote; and (2) at least 80 percent of the total number of shares of each of the other classes of the corporation's stock.⁹⁶ P stock is transferred to the shareholders of T in the merger of T into B.

⁹⁶ Thus, the relationship between A and P satisfies the control requirements of IRC § 368(c)

This transaction, known as a forward triangular merger, satisfies the Final Regulations because the assets and liabilities of the transferor unit, T, become the assets and liabilities of B, a member of A's transferee unit. The use of stock of a corporation that controls A is authorized if the requirements of Code § 368(a)(2)(D) are met. This requires that no stock of the acquiring corporation, A, be used in the transaction, and that the transaction would qualify as an "A" reorganization if the merger was into the controlling corporation, P. *See* Prop. Reg. § 1.368-2(b)(1)(iv) Example 3.

In Priv. Ltr. Rul. 200528021 (April 8, 2005), the IRS addressed a taxpayer that was an S corporation that wanted to convert to an LLC, for business reasons. As a newly formed LLC, it would elect treatment as an association taxable as a corporation, and would never exist as a partnership for Federal income tax purposes. The taxpayer sought to qualify this conversion as a reorganization pursuant to Section 368(a)(1)(A).

The new LLC would be essentially the same as the old S corporation. The fair market value of the membership interests in the LLC would be the same as the fair market value of the stock in the corporation. No shareholder would sell or dispose of any shares; neither the corporation nor the LLC would redeem or reacquire any shares; and there would be no new shareholders or members. In addition, the new LLC would take all the assets, which it would not sell, and assume all the liabilities of the old corporation.

Given these and other facts, the Service concluded that the conversion to an LLC, to be treated as an association and taxed as a corporation, qualified as a reorganization under Section 368(a)(1)(F). No party would recognize any gain or loss; the basis in all assets and shares would be carried over; and holding periods would be tacked. In addition, the new entity would retain the S corporation status for tax purposes.

b. Corporation/Partnership Mergers

Louisiana law allows a corporation to merge into a partnership and allows a partnership to merge into a corporation. Even though allowed by state law, where the acquiror is a corporation and the target is a tax partnership, the businesses usually cannot combine tax-free in a single transaction. The Final Regulations require corporations, or "combining entities," to exist on both sides of the transfer. The other reorganization rules in Code § 368(a)(1) also require transactions between corporations. Recent partnership merger regulations under Code § 708, which are discussed below, require tax partnerships on both sides. *See* Treas. Reg. § 1.708-1(c).

A tax partnership can transfer all of its assets and liabilities to a corporation, but, immediately after the exchange, the transferors must have control of the corporation (at least 80% of all classes of stock - IRC §368(c)) to qualify for tax-free treatment as a transfer to a controlled corporation under Code § 351. This accommodates only the rare situation where the fair market value of the tax partnership's assets is considerably greater than the fair market value

of the corporation's assets; or the continuing shareholders are willing and able to contribute a non-*de minimis* amount in the same transaction.

A tax free combination might be accomplished if the corporate acquiror instead becomes a partner of the target tax partnership. The corporate acquiror could also form a new LLC into which the target business is contributed, but the pre-existing members of the target would not become equity owners in the corporate acquiror so we still do not accomplish the same result as in a tax free corporate reorganization.

The pre-existing members of the tax partnership could achieve such an interest if the acquiring corporation contributes all of its assets and liabilities to the target partnership or new LLC in exchange for its partnership interest. However, if a partner of the target entity wishes to "cash out" in the transaction, the parties will more than likely be treated as having engaged in a disguised sale of a portion of the LLC's property under Code § 707 and the regulations thereunder.

Alternatively, the target partnership could either transfer all of its assets and liabilities into a newly formed corporation in a tax-free Code § 351 transaction or elect to be treated as an association for tax purposes. This new corporation could merge with the corporate acquiror. The problem with this approach is the merger and the incorporation or election is likely to be treated as a single Code § 351 transaction. *See* Rev. Rul. 68-357, 1968-2 C.B. 144.

As a result, if the new corporation survives the merger, the partnership (in the event of an incorporation) or the partners (in the event of an election to be treated as an association) would be tested together with the shareholders of the corporate acquiror for purposes of the "control" test under Code § 351, which may allow the transaction to satisfy its requirements. *See West Coast Marketing Corp. v. Comm'r*, 46 T.C. 32 (1966). On the other hand, if the corporate acquiror survives the merger, the shareholders of the corporate acquiror will not be part of the group that is tested for Code § 351 "control" purposes. Under these facts, the transfer more than likely will be taxable unless the shareholders of the corporate acquiror end up with less than 20 percent of the combined business entity. *See* Rev. Rul. 70-140, 1970-1 C.B. 73; Rev. Rul. 54-96, 1954-1 C.B. 111, *modified on other grounds*, Rev. Rul. 56-100, 1956-1 C.B. 624.

In Rev. Rul. 2004-59, 2004-24 I.R.B. 1050, the IRS provides that, for Federal tax purposes, a partnership that converts to a corporation under a state law formless conversion statute will be treated in the same manner as one that makes an election to be treated as an association under Reg. Section 301.770-3(c)(1)(I). Thus, when unincorporated entity A converts, under state law, to corporation A, the following steps are deemed to occur: unincorporated entity A contributes all of its assets and liabilities to corporation A in exchange for stock in corporation A, and immediately thereafter, unincorporated entity A liquidates, distributing the stock of corporation A to its partners. The IRS noted that Rev. Rul. 84-111, 1984-2 C.B. 88, which describes the three methods of incorporating a partnership, does not apply where a partnership incorporates under a state formless conversion statute.

Baringer
Advance Tax Issues

c. Partnership Combinations

Under IRC §708, an existing tax partnership is considered as continuing if it is not terminated. For purposes of that rule, a partnership is considered as terminated only if (a) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (b) within a 12 month period there is a sale or exchange of 50% or more of the total interest in the partnership capital and profits.

§708 provides further that in the case of a merger or consolidation of two or more partnerships, the resulting partnership shall be considered as the continuation of any merging or consolidating partnership whose members own an interest of more than 50% in the capital and profits of the resulting partnership.

In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than the partnership the members of which had an interest of 50% or less in the capital and profits of the prior partnership) shall, for purposes of §708, be considered a continuation of the prior partnerships.

Thus, an LLC taxed as a partnership that desires to acquire the business of another tax partnership may merge tax-free under Code § 708 if neither of the merging partnerships is treated as having terminated under §708.

New regulations (the “Partnership Merger Regulations”) apply to partnership mergers that occur on or after January 4, 2001. The regulations concentrate on: (1) which tax partnerships continue, terminate, or are created; and (2) the form of the transaction.

The Resulting Partnership

For purposes of the Partnership Merger Regulations, the tax partnership that survives for state law purposes is the “resulting partnership.” To determine which tax partnership continues, or whether a new tax partnership is created, the Partnership Merger Regulations look at three questions:

1. *Do members of the merging tax partnerships obtain more than 50 percent of the interests in capital and profits in the resulting partnership?* If, for example, persons who were not members of either tax partnership before the merger become members in the merger and these new members obtain more than 50 percent of the capital and profits interests, the resulting partnership is a new tax partnership.

2. *Do members of any one merging tax partnership own more than 50 percent of*

the capital and profits interests in the resulting partnership? If so, the resulting partnership is a continuation of the tax partnership whose members own the majority of the capital and profits interests in the resulting partnership.³ *If more than one tax partnership could be treated as continuing under the previous test, which of those tax partnerships contributes the greatest net fair market value of assets to the resulting partnership?* The resulting partnership is the continuation of the tax partnership contributing the most assets, as measured by net fair market value. This sequence of questions should, in almost all situations, enable the practitioner to determine whether the resulting partnership is a new tax partnership or a continuation of one of the merging tax partnerships.

Example 1: Assume that two members own an LLC (“A”), with each owning 50 percent of capital and profits. A is interested in acquiring the business of another LLC (“B”), which is owned by four members, each owning 25 percent of capital and profits. A's assets and liabilities have a net fair market value of \$150x and B's assets and liabilities have a net fair market value of \$100x.

In this example, the first question (whether the merging tax partnerships' members obtained more than 50 percent of the capital and profits in the resulting partnership) may be answered affirmatively because the resulting partnership will be wholly owned by the members of the merging tax partnerships. Only A can affirmatively answer the second question (whether its members own more than 50 percent of the capital and profits interests in the resulting partnership) because its members will own more than 50 percent of the interests in capital and profits in the resulting partnership. Each member of A contributes \$75x of net fair market value, and each member of B is contributing \$25x of net fair market value, with the combined partnership worth \$250x. In such a case, each former member of A will have a 30 percent interest in capital and profits in the combined partnership, meaning that the two former members of A will have 60 percent of the interests in capital and profits. (See Table 1.) Due to the fact that only one LLC can answer the second question affirmatively, the third question is not relevant. The resulting tax partnership will be a continuation of A and the combination will be tax-free to B and its owners, as described below. See Treas. Reg. § 1.708-1(c)(5) Example 1.

Table 1 (Example 1)

Before	After
A1 50% x 150x W 75x	75x / 250x W 30%
A2 50% x 150x W 75x	75x / 250x W 30%
B1 25% x 100x W 25x	25x / 250x W 10%
B2 25% x 100x W 25x	25x / 250x W 10%
B3 25% x 100x W 25x	25x / 250x W 10%
B4 25% x 100x W 25x	25x / 250x W 10%

Table 2 (Example 2)

	Before	After
A1	50% x 100x W 50x	50x / 250x W 20%
A2 in A	50% x 100x W 50x	-
A2 in AB	-	87.5x / 250x W 35%
A2 in B	25% x 150x W 37.50x	-
B1	25% x 150x W 37.50x	37.50x / 250x W 15%
B2	25% x 150x W 37.50x	37.50x / 250x W 15%
B3	25% x 150x W 37.50x	37.50x / 250x W 15%

Example 2: The result will change if one member of A also is a member of B. (See Table 2.) Assume that A is owned by two members (A1 and A2) and that B is owned by four members (A2, B1, B2, and B3). A's assets and liabilities have a net fair market value of \$100x and B's assets and liabilities have a net fair market value of \$150x. In this scenario, the resulting partnership will have five members. The member that was only a member of A (A1) will have a 20 percent interest in capital and profits in the resulting partnership. The three members of B that were not members of A (B1, B2, and B3) will each end up with a 15 percent interest in capital and profits. This is because each member of A is contributing \$50x, and each member of B is contributing \$37.50x of net fair market value to a combined partnerships worth \$250x. The person who was a member of A *and* B (A2) will end up with a 35 percent interest in capital and profits.

The merging tax partnerships' members obtained more than 50 percent of the capital and profits in the resulting partnership. Thus, the first question (whether the merging tax partnerships' members obtained more than 50 percent of the capital and profits in the resulting partnership) can be answered in the affirmative. Therefore, one of the prior LLCs continued for tax purposes and no new tax partnership was created for tax purposes.

The second question also can be answered affirmatively for both LLCs—namely, the members of each own more than 50 percent of the capital and profits interests in the resulting partnership. The former members of A (A1 and A2) own 55 percent of the capital and profits, and the former members of B (A2, B1, B2, and B3) own 80 percent of the capital and profits.

Finally, to answer the third question, B will be the tax partnership that contributed assets with the greatest net fair market value. Thus, B will be the resulting partnership, with the tax consequences described below. See Treas. Reg. § 1.708-1(c)(5) Example 2.

The Form of the Transaction

With respect to the issue of form in a partnership merger, the merger may take either the

“Assets Up Form” or the “Assets Over Form.” The form chosen by the parties generally is respected.

The Assets Up Form requires two steps. First, the terminated tax partnership distributes all of its assets to its members, such that the members become the owners of the assets for state law purposes, in liquidation of that tax partnership. Second, the members immediately contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership. *See* Treas. Reg. § 1.708-1(c)(3)(ii).

If the parties do not follow the Assets Up Form, the terminated tax partnership generally is treated as: (1) contributing all of its assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership; and (2) distributing the interests in the resulting partnership to its members in liquidation (the Assets Over Form). Treas. Reg. § 1.708-1(c)(3)(I).

However, the Assets Up Form and the Assets Over Form are not respected if the merger is part of a larger series of transactions, the substance of which is inconsistent with following that form. *See* Treas. Reg. § 1.708-1(c)(6). In general, the form of the transaction may affect the taxability of any transfers, as well as the basis, holding period, depreciation schedules, and other attributes of the transferred assets. For example, under the Assets Up Form, the taxability of the distribution of assets will be tested under Code §§ 731, 735, and 751, but the contribution of assets to the resulting partnership should be tax-free pursuant to Code § 721.

By contrast, under the Assets Over Form, the contribution of assets should be tax-free pursuant to Code § 721. In addition, under the Assets Over Form, the distribution of the partnership interest in the resulting partnership should be tax-free under Code § 731. Under the Assets Over Form, a partner of the resulting partnership will be taxable only to the extent of any debt shifts that cause deemed distribution in excess of basis. *See* Treas. Reg. § 1.708-1(c)(6). The resulting partnership should not experience any taxability under either form of transaction.

The following examples demonstrate the application of this portion of the Partnership Merger Regulations. The underlying facts of these examples are the same as those described in “The Resulting Partnership” section, above.

Example 3: In Example 1, above, the members of A ended up with more than 50 percent of the capital and profits, meaning that A continued and B terminated for tax purposes. Assume that A and B combine pursuant to a state statute which allows a combination of two LLCs or a partnership and an LLC without prescribing the form in which this occurs. Because the members of the terminated LLC (B) did not distribute the assets of B in liquidation, the merger will be treated as following the Assets Over Form, such that B is deemed to have contributed all of its assets and liabilities to A in exchange for an interest in A. B then will be treated as distributing the interest in A to its members. As described above, absent

Baringer
Advance Tax Issues

a debt shift from a member of A in excess of the member's basis in his or her membership interests, the entire transaction should be tax-free to all of the parties involved. The taxable year of B will end on the date of the merger, and B will file a return for the taxable year through that date. However, A will need to file a full-year tax return, disclosing the merger on the return.

Example 4: Federal tax law may treat a partnership merger transaction differently from state law. In Example 2, above, B transferred more net asset value to the resulting partnership and continues, for tax purposes, while A terminates. For state law purposes, assume that B contributed its assets to A in exchange for membership interests in A, and B immediately distributed the membership interests to its members in liquidation. For federal tax purposes, because the terminated LLC (A) did not distribute its assets to its members, A will be treated as contributing its assets to B (the opposite direction as under state law) in exchange for a membership interest in B. A will be treated as liquidating, for federal tax purposes, and distributing the interests in B to its members.

In this transaction, the contribution of A's assets to B will be tax-free under Code § 721 and the distribution of the interest in B to A's members will be tax-free under Code § 731. The resulting partnership, B, continues. For tax purposes, B has not exchanged anything and will not be taxable on this transaction. Each member of B also will not experience taxation if the debt shift away from that member, if any, is less than each individual's basis in his or her interests in B.

If any members of the combining tax partnerships will receive property other than an interest in the resulting partnership, those members may be liable for a tax on this "boot." Any sale of all or part of a member's interest in a terminated tax partnership to the resulting partnership will be respected as a sale of a tax partnership interest (subject to the rules of Code §§ 741, 743, and 751) if the merger agreement specifies that the resulting partnership is purchasing interests from a particular member in the merging tax partnership and specifies the consideration that is transferred for each interest sold. *See* Treas. Reg. § 1.708-1(c)(4). In addition, the selling member must consent to treat the transaction as a sale of the tax partnership interest, either prior to or contemporaneously with the transaction. In other words, if partners will be receiving money or property other than partnership interests, the partners receiving that consideration will be treated as selling a portion of their partnership interest. *See* Treas. Reg. § 1.708-1(c)(5) Example 5. Depending on the circumstances, a partner who receives money or property other than a partnership interest in the resulting partnership and does not comply with the requirements of this regulation may be treated as selling his or her ratable share of the assets of the terminated partnership under the disguised sale rules. Alternatively, the partner may be treated as receiving a distribution that may be taxable or tax-free under IRC §§ 731 and 751.

As a result of the Final Regulations and the Partnership Merger Regulations proposed and promulgated, respectively, by the Treasury during 2001, tax-free acquisitions will be more easily

Baringer
Advance Tax Issues

structured between corporations and between tax partnerships. The Final Regulations now allow a corporation with a wholly owned LLC to merge a target corporation into that LLC in a tax-favored Code § 368(a)(1)(A) reorganization. In addition, an LLC that is taxed as a partnership and desires to acquire another business operated within a tax partnership may do so under the Partnership Merger Regulations.

Difficulties develop where a corporation wants to acquire a tax partnership and the members of the target want an equity interest in the entire combined business. The corporation generally cannot do this without either creating a taxable transfer or contributing its assets and liabilities to the tax partnership. Potential disguised sale issues will arise if any of the members of the target would like to receive cash instead of a continuing interest in the business.

Regardless of the potential problems faced by mismatched entities, any business that may be engaged in acquisitions should be thinking about the possibility of using the LLC in the acquisition structure. The LLC enables an acquiror to interact with corporate targets and tax partnership targets, due in large part to the advent of statutes allowing mergers between different types of entities and the ability of the LLC, under the check-the-box regulations, to be either disregarded or treated as a tax partnership or taxed as a corporation. The development of state law (in allowing different types of entities to combine)-and federal tax law (in relaxing the requirements for certain tax-free reorganization)-thus have created a more lenient environment for these types of acquisitions.

J. Conversions From One Form of Entity to Another

a. Conversion from a Corporation to a Partnership.

The conversion from a corporation to a partnership or to an LLC that qualifies for partnership taxation is treated as a liquidation of the corporation with accompanying distribution of its assets to the stockholders and a contribution of those assets to a partnership. On liquidation, the corporation generally recognizes gain or loss as if its assets were sold for their fair market value. IRC §336(a). Certain losses are disallowed on the liquidation of a corporation. §336(d). No gain or loss is recognized, however, on a liquidating distribution to a corporate shareholder that owns 80% or more of the stock by vote and value of the liquidating corporation. §337. Otherwise, each shareholder of the liquidating corporation generally recognizes gain or loss to the extent of the difference between the amount realized from the liquidating distribution and the adjusted basis of the shareholder's stock. §331. After the liquidation, the former shareholders of the corporation are treated as if they contributed the corporate assets received in the distribution to the LLC/partnership in a tax free transaction. §721. In many cases where a corporation converts to an LLC taxed as a partnership, the LLC will receive a step-up in basis of the corporate assets and the members will step up their bases in their interests in the LLC. This is on account of the gain which is realized upon receipt of the distribution from the corporation, which gain is added to the bases of the property received. IRC §§331, 334 & 1223. When the property is transferred to the partnership, the basis and holding period will carry over without recognition of gain or loss

Baringer
Advance Tax Issues

in accordance with the general rules of IRC §§721 & 723.

As a result of the repeal of *General Utilities* by the Tax Reform Act of 1986, the general rule that gain or loss is recognized on liquidating distributions makes conversion of a corporation into a partnership generally ill-advised. If an S corporation conversion to an LLC taxed as a partnership is considered, there will be a single level of tax at the shareholder level. If a C corporation is involved, there will be two levels of tax upon the liquidation. The general rules for transferring property to a partnership will then apply when the shareholders transfer what is left to the partnership.

b. Conversion From a Partnership to an LLC Taxed as a Partnership.

The conversion from a partnership to an LLC taxed as a partnership may be tax-free and does not result in a termination of the partnership if both the partnership and the LLC qualify as partnerships for tax purposes. Rev. Rul. 95-55, 1995-35 I.R.B. __; Rev. Rul. 95-37, 1995-17 I.R.B. 10 (conversion of a general partnership into an LLC is tax free where the LLC is classified as a partnership for federal tax purposes and there is no change in any partner's share of partnership liabilities after the conversion). See also Rev. Rul. 84-52, 1984-1 CB 157. The conversion does not cause a partnership termination under IRC §708. See also PLR 9511033. 9443024, 9412030. Since each partner in the converting partnership continues to hold an interest in the LLC, the conversion is not a sale, exchange or liquidation of the converting partner's entire partnership interest within §706(c). The conversion does not cause the taxable year of the domestic partnership to close with respect to all the partners or with respect to any partner. Rev. Rul. 95-37.

The LLC resulting from the conversion does not have to obtain a new tax identification number. Rev. Rul. 95-37.

c. Conversion from a C Corporation to S Corporation.

In general, converting a C corporation to an S corporation is not deemed to involve a transfer, however, this conversion may result in significant collateral effects involving issues such as built-in gains, income from passive activities, loss carryovers, etc., as were discussed above. Because an S corporation election may only be made for a full taxable year, there is no problem of a short taxable year created upon conversion from C to S status. The built-in gains tax is imposed only when the built-in gain is realized, not at the time of the conversion, and only if the built-in gain is realized within the ten years after the date of the conversion. The 2010 Small Business Jobs Act temporarily shortens the holding period of assets subject to the built-in gains tax to 5 years if the 5th tax year in the holding period precedes the tax year beginning in 2011. The tax applies to gains realized on the sale of property owned by the corporation while it was a C corporation. It includes gains on assets such as inventory and receivables. The built-in gain may be offset by net operating loss and other carryforwards from C corporation years. IRC

Baringer
Advance Tax Issues

§1374(b)(2). The tax reduces the built-in gains passing through to the shareholders of the S corporation. Net operating losses during the S corporation years may offset the gains recognized. This offset may use up a loss that would otherwise be deductible by the shareholders. When applicable, the built-in gains tax is paid at the appropriate C corporation tax rate.

In general, when a C corporation converts to an S corporation, any net operating loss or other carryforwards of the C corporation at the time of the election are not available to the S corporation in determining the subsequent income taxable to its shareholders. The losses are also not available to the shareholders as they would be if incurred in an S corporation year.

d. Conversion from an S Corporation to a C Corporation.

The conversion of an S corporation to a C corporation is not a realization event and does not produce significant tax consequences. Once an S election terminates, there is a transition period of generally one year during which accumulated S period earnings may be distributed to shareholders without being treated as taxable dividends. I.R.C. §1371(e) & 1377(b). Any amounts not distributed during the transition period become subject to normal C corporation distribution rules, but are not considered earnings and profits. If the shareholders of an S corporation have substantial unused losses which were unavailable to them because their basis had been used up, they can use these losses against income if their basis increases. The earnings of the C corporation, however, do not increase basis for this purpose. S corporations with large unused losses should not convert to C corporation status absent other significant reasons for doing so.

e. Incorporation of an Existing Partnership.

This can take one of three different forms. Under one form, all of the assets (subject to all the liabilities) of the partnership are transferred by the partnership to the corporation, in exchange for all of the corporation's stock. Then the partnership liquidates and distributes the stock to the partners according to their respective interests. Under the second form, the partnership terminates, distributing all of its assets (subject to all of its liabilities) to the partners, then the partners transfer all the assets and liabilities received in the distribution to the corporation in exchange for all of the corporation's stock. In the third form, all of the partners transfer their respective partnership interests to the corporation in exchange for all of the corporation's stock. This terminates the partnership (the corporation is the only partner) and the corporation owns all of the partnership's assets.

For many years, the position of the IRS was that when a partnership was incorporated, with all of the assets and all of the liabilities of the partnership becoming assets and liabilities of the corporation, the income tax consequences were the same no matter what form the transaction took. Rev. Rul. 70-239, 1970-1 C.B. 74. Regardless of the form of the transaction, the partnership was regarded as the transferor, the partnership transferred the operating assets and

Baringer
Advance Tax Issues

liabilities to the corporation in exchange for stock under IRC §351, followed by the liquidating distribution of stock to the partners. In 1984, the IRS revoked Rev. Rul. 70-239 and superseded it with Rev. Rul. 84-111, 1984-2 C.B. 88. The key issue is who is the transferor? What is the transferee corporation receiving in the exchange, all of the partnership interests or all of the partnership's assets and liabilities? Stated another way, who is the "transferor", the partners or the partnership? One should be concerned about the form of the transaction when there is a difference between the partnership's basis in its assets and the partners' basis in their partnership interests. This can occur when partners have purchased or inherited their interests and no §754 election was made. In most cases where there is a difference between the partners' and the partnership's basis, the parties should seek the transaction form that will give the corporation the highest possible basis in the assets received. Under the first alternative form (partnership exchanges assets and liabilities for stock, then distributes stock to partners), the partnership is the transferor and the corporation takes as its asset basis the partnership's basis in the assets. IRC §362(a). Under the second alternative form (partnership distributes assets and liabilities to partners, then partners exchange assets and liabilities for stock), the partners are the transferors, and IRC §362(a) states that the corporation takes as its basis the partner's basis in their respective partnership interests pursuant to IRC §732(b).

Under Rev. Rul. 84-111, when the partners transfer their partnership interests to the corporation, the corporation's basis for the assets received equals the partners' basis in their partnership interests.

f. Taxation on Sales of an Interest - Handling the Holding Period and Hot Asset Issues

A transfer of a partnership interest is viewed as a transfer of an interest in the partnership itself, rather than as a transfer of interests in the assets of the partnership. Under IRC §741, gain or loss recognized by the seller of a partnership interest is generally treated as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in §751 relating to unrealized receivables and inventory (commonly known as "hot assets"). Under §742, the transferee's basis in the interest is determined under the generally applicable basis rules in §§1011 through 1015. The basis of partnership assets, however, is not affected by the transfer unless the partnership elects under §754 to be subject to the optional basis adjustment provisions in connection with transfers and distributions. In this case, the basis of partnership assets is adjusted with respect to the transferee to reflect the initial basis of his partnership interest. [IRC §743(a) & (b)]. The special exception to the capital gain rule of §741 for inventory and receivables is provided to prevent the conversion of potential partnership ordinary income into capital gain through timely sales of partnership assets.

Under §751(a), the transferor's gain or loss with respect to his share of partnership unrealized receivables and substantially appreciated inventory is computed separately and characterized as ordinary income or loss. Where the partnership holds §751 property, the income or loss realized by a partner upon sale or exchange of its interest in §751 property is the amount of

Baringer
Advance Tax Issues

income or loss that would have been allocated to the partner if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately before the partner's transfer of the interest in the partnership. Gain or loss attributable to §751 property is ordinary gain or loss and the difference between the amount of capital gain or loss that the partner would realize in the absence of §751 and the amount of ordinary income or loss is capital gain or loss.

Partnership interests are subject to the installment sale rules of IRC §453. If a partnership interest is sold and at least one payment is due after the tax year in which the sale occurs, the installment method generally must be used to report the gain unless the taxpayer elects not to report the gain on the installment sale method. However, according to the IRS in Rev. Rul. 89-108, 1989-2 CB 100, a partner's income from the sale of a partnership interest cannot be reported on the installment method to the extent it represents income attributable to the partnership's inventory that would not be eligible for installment sales treatment if sold directly. The installment sale method generally is not available for sales of inventory under IRC §453(b)(2)(B). The installment sale method is available for the balance of the income realized by the partners from the sale of the partnership interest.

Additionally, depreciation recapture income is fully recognized in the year of an installment sale of depreciable property. Recapture income for this purpose is the aggregate amount that would be treated as ordinary income under IRC §1245 or §1250 for the tax year of the disposition if all payments to be received were received in the tax year of disposition. Thus, an installment sale of a partnership interest which includes §751 property of a depreciation recapture type will result in full recognition of the recapture income.

Distributions may be treated as sales or exchanges between the distributee partner and the partnership under §751(b). This rule applies to the extent a partner receives in a distribution:

- (a) partnership unrealized receivables or substantially appreciated inventory ("SAI") in exchange for all or a part of his or her interest in other partnership property (including money), or
- (b) partnership property (including money) other than unrealized receivables or substantially appreciated inventory in exchange for all or a part of his or her interest in such receivables or inventory.

The deemed sale or exchange rule does not apply to:

- (a) a distribution that the distributee contributed to the partnership, or
- (b) payments to a retiring partner or a deceased partner's successor in interest that are

treated as a distributive share of partnership income or guaranteed payments under IRC §736(a).

This disproportionate distribution rule overrides the general rules of §731 under which gain or loss is not generally recognized to a distributee partner in the case of partnership distributions. Thus, generally, if a partner receives §751 property in exchange for other partnership property the partnership has ordinary income. If the partner receives other property in exchange for §751 property he or she has ordinary income. The gain or loss on the other property in the deemed exchange may be capital gain or loss or ordinary income or loss depending on the nature of the other property. The disproportionate distribution rule applies whether or not the distribution is in liquidation of the distributee's entire interest in the partnership, and has been held to apply even if the distribution involved terminates the partnership. *Yourman v. U.S.*, 277 F. Supp. 818 (1967, DC CA).

Where a partner receives, in a liquidation of a partnership, a distribution in kind of his proportionate share of assets that would be substantially appreciated inventory, the distribution did not constitute a sale or exchange under §751. *Rev. Rul. 57-68*, 1957-1 CB 207.

The disproportionate distribution rule does not apply to any distribution to a partner that is not in exchange for his or her interest in other partnership property. Thus, the rule does not apply to the extent that a distribution consists of the distributee partner's share of unrealized receivables or substantially appreciated inventory or his or her share of other property. The rule also does not apply to current drawings or to advances against the partner's distributive share, or to distributions that are actually gifts or payments for services or for the use of capital. In determining if a partner has received only his or her share of §751 property or of other property, the partner's interest in such property remaining in the partnership after the distribution is considered.

When a partner receives more than his or her share of §751 property in exchange for part of his or her interest in other partnership property, the partnership is treated as having sold the excess §751 property to the distributee for the other property the distributee has relinquished. The partnership realizes ordinary income or loss on the sale or exchange measured by the difference between the adjusted basis to the partnership of the §751 property treated as sold or exchanged and the fair market value of the distributee's interest in the other property relinquished.

The distributee partner realizes gain or loss measured by the difference between his or her adjusted basis for the property relinquished in the exchange and the fair market value of the §751 property received for the relinquished property. The distributee's basis for the relinquished property is the basis the property would have had under IRC §732 if the distributee partner had received that property in a current distribution immediately before the actual distribution that is

Baringer
Advance Tax Issues

treated wholly or partly as a sale or exchange under §751(b). Reg. §1.751-1(b)(2)(iii).

Example. The ABCD partnership has three assets: cash of \$200,000, inventory that is substantially appreciated (“SAI”) with a basis of \$40,000 and a fair market value of \$100,000, and land that has a basis of \$100,000 and a fair market value of \$100,000. A, a one-fourth partner, receives a distribution consisting of all of the SAI in liquidation of A’s entire interest. A is considered to have bought the \$75,000 of SAI in excess of A’s share (the part he had no previous interest in) with his one-fourth interest in cash (\$50,000) and A’s one-fourth interest in the land (\$25,000). A recognizes no gain or loss since the property A gave up was entirely cash or land with a value equal to its basis. The partnership is considered to have sold the excess of \$75,000 in SAI for \$50,000 in cash and \$25,000 in land that was given up by A. Thus, the partnership recognizes a gain of \$45,000 (the difference between the \$75,000 of the SAI sold and the \$30,000 of basis allocated to that SAI. The gain is ordinary income. A’s basis in the inventory is \$85,000 after the distribution (\$75,000 basis in inventory received in excess of A’s interest plus \$10,000 basis in the rest of the inventory).

When a partner gives up any part of his interest in §751 property in return for receiving more than his or her share of other partnership property, the partnership is treated as having sold the excess property. The partnership realizes gain or loss on the sale or exchange of the other property measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold or exchanged and the fair market value of the distributee partner’s interest in the §751 property which he or she relinquished in the exchange. The character of the partnership’s gain or loss is determined by the character of the distributed property treated as sold or exchanged by the partnership. Reg. §1.751-1(b)(3)(i) and Reg. §1.751-1(b)(3)(ii).

The distributee realizes ordinary income or loss on the sale or exchange of §751 property measured by the difference between his or her adjusted basis for the §751 property relinquished in the exchange and the fair market value of the other property received by him or her in exchange for the interest in the §751 property that was relinquished. Reg. §1.751-1(b)(3)(iii).

Example. The ABCD partnership has three assets: cash of \$200,000, inventory that is substantially appreciated (SAI with a basis of \$20,000 and a fair market value of \$100,000) and land with a basis of \$100,000 and a fair market value of \$100,000. B, a one-fourth partner, receives a distribution in cash of \$100,000 in liquidation of his entire interest. The cash received does not exceed B’s basis in his partnership interest so he has no gain under §731. B is considered to have exchanged his one-fourth interest in SAI for \$25,000, which equals \$50,000 (excess of \$100,000 cash received over his \$50,000 proportionate interest in the partnership cash) less \$25,000 allocable to his interest in land. B is considered to have \$20,000 of ordinary income based on the difference between \$25,000

Baringer
Advance Tax Issues

received for his interest in SAI and the \$5,000 share of the SAI basis allocable to SAI given up. The partnership has no gain or loss on the deemed exchange since it is treated as acquiring B's interest in SAI for cash. The \$25,000 that the partnership paid for B's interest in SAI is added to the partnership's basis (\$15,000) in the unsold portion of the SAI so that the partnership's basis increases to \$40,000.

A partnership that distributes §751 property to a partner in exchange for his or her interest in other partnership property, or that distributes other property in exchange for any part of the partner's interest in §751 property must include with its return a statement showing the computation of any income, gain or loss to the partnership under §751(b). The distributee also must include with his or her return a statement showing the computation of any income, gain or loss to him or her. The statement must include information similar to that required under Reg. §1.751-1(a)(3) explained under "Information Reporting." Reg. §1.751-1(b)(5).

In a §736 liquidation a partnership makes a distribution (or a series of distributions) that terminates a partner's interest in a partnership. Payments to the withdrawing partner in the liquidation are ordinary income to that partner unless made in exchange for the partner's interest in partnership property under IRC §736(b). Payments to a withdrawing partner in liquidation of the partner's entire interest, that are not made in exchange for the partner's interest in partnership property, are either guaranteed payments or distributive share income. If the amount of the payment is determined without regard to the income of the partnership it is a guaranteed payment. Payments determined with regard to the partnership's income are distributive share income.

The disproportionate rule overrides the general rules on distributions in IRC §731 through §736 but does not apply to payments to a retiring partner or a deceased partner's successor in interest that are treated as a distributive share of partnership income or guaranteed payments under §736. Payments to a retiring partner or to a deceased partner's successor in interest under IRC §736 must first be divided between payments under §736(a) and §736(b). If there is an exchange of substantially appreciated inventory items for other property, the §736(b) payments must be divided between the payments treated as a sale or exchange under §751(b) and payments treated as distributions under §731 through §736. Reg. §1.751-1(b)(4)(ii).

g. Using Elections to Make Optional Basis Adjustments to Minimize Tax in Distributions

Under IRC §§734, 743 and 754 of the IRC, the partnership may adjust its basis in partnership assets in order to give a purchaser of a partnership interest a cost basis in his share of partnership assets. Basis adjustment also available for step up in basis at death of a partner. Property (such as a partnership interest) passing from a decedent at death takes a tax basis in the hands of the heirs equal to fair market value at the date of death. Under §743, if an election is filed under §754 by the partnership, the partnership's basis in its assets, to the extent allocable to

Baringer
Advance Tax Issues

the partnership interest which has passed at death, is increased to fair market value of the partnership interest. Similar basis adjustment is available in the case of gain or loss on certain distributions of partnership property to a partner.

Example 1: ABCD partnership owns Blackacre with a basis of \$100 and a fair market value of \$200. The partners each have a 25% sharing ratio in partnership profits, losses and capital. E purchases A's partnership interest for \$50, reasoning that he is acquiring the near equivalent of a 25% in the land valued at \$200. If ABCD sells Blackacre for its fair market value of \$200, E has a taxable gain of \$25, even though he paid the equivalent of his pro rata share of the \$200 fair market value. To avoid this incongruity, the partnership can elect to increase the basis of Blackacre inside the partnership, solely for purposes of partner E to the \$50 price paid by partner E.

K. Recent Developments

(a) The New Healthcare Laws.

H.R. 3590, the Patient Protection and Affordable Care Act (PL 111-148, 3/23/2010), as Amended by H.R. 4872, the Health Care and Education Reconciliation Act of 2010 (PL 111-152, 3/30/2010). The Patient Protection and Affordable Care Act is sometimes referred to herein as the "Health Care Act." The Health Care and Education Reconciliation Act of 2010 which amends the Health Care Act, and is sometimes referred to herein as the "Reconciliation Act".

These are over twenty new or higher taxes in the new health care legislation. Several will first go into effect on January 1, 2011. They include:

The "Medicine Cabinet Tax" Taxpayers will no longer be able to use health savings account (HSA), flexible spending account (FSA), or health reimbursement (HRA) pre-tax dollars to purchase non-prescription, over-the-counter medicines (except insulin) unless prescribed by a physician.

The "Special Needs Kids Tax" This provision of Obamacare imposes a cap on flexible spending accounts (FSAs) of \$2500 (Currently, there is no federal government limit). There is one group of FSA owners for whom this new cap will be particularly cruel and onerous: parents of special needs children. There are thousands of families with special needs children in the United States, and many of them use FSAs to pay for special needs education. Under tax rules, FSA dollars can be used to pay for this type of special needs education.

The HSA Withdrawal Tax Hike. This provision increases the additional tax on non-medical early withdrawals from an HSA from 10 to 20 percent,

Baringer
Advance Tax Issues

disadvantaging them relative to IRAs and other tax-advantaged accounts, which remain at 10 percent.

Many more of the new tax provisions enacted under the new health care law will come into effect over the next several years.

- Tax Changes Relating to Universal Health Coverage Mandate

- **Penalty for remaining uninsured** - after Dec. 31, 2013, non-exempt U.S. citizens and legal residents failing to maintain “minimum essential coverage” shall pay a penalty. The penalty is the greater of a percentage of household income in excess of the threshold amount requiring the filing of a federal income tax return or fixed dollar amount per household member, which is gradually phased in between 2014 and 2016.

- In 2014 the penalty is greater of 1% of the excess income over the filing threshold amount or \$95 per uninsured adult household member (one-half the adult dollar amount for uninsureds under age 18);

- In 2015 the penalty is greater of 2% of the excess income over the filing threshold amount or \$325 per uninsured adult household member (one-half the adult dollar amount for uninsureds under age 18);

- In 2016 the penalty is greater of 2.5% of the excess income over the filing threshold amount or \$695 per uninsured adult household member (one-half the adult dollar amount for uninsureds under age 18).

- The total household penalty is capped at 300% of the per adult penalty (\$2,085), and shall not exceed the national average annual premium for the “bronze level” health plan offered through the Insurance Exchange that year for the applicable household size.

- For years after 2016, the per adult dollar amount will be indexed to CPI-U, rounded to the next lowest \$50. Spouses filing a joint return are jointly liable for any penalty payment. The penalty is in the form of a tax penalty imposed under the IRC, which will apply to any period the individual does not maintain “minimum essential coverage” (determined monthly).

- Under new IRC §5000A, exemptions from the requirement for maintaining “minimum essential coverage” are provided for:

- individuals who cannot afford coverage because their required contribution for employer sponsored coverage or the lowest cost “bronze

Baringer
Advance Tax Issues

plan” in the local Insurance Exchange exceeds 8% of household income;

- those who are exempted for religious reasons; and
- those residing outside of the U.S.

• **Low-income tax credits for participating in health exchanges.** Under new IRC §36B and various provisions of the new law, after 2013, tax credits will be available for individuals and families with incomes up to 400% of the federal poverty level (\$43,320 for an individual or \$88,200 for a family of four) that are not eligible for Medicaid, employer sponsored insurance, or other acceptable coverage. These individuals and families will have to obtain health care coverage in newly established Insurance Exchanges in order to obtain credits. A "cost-sharing subsidy" will be provided to low income individuals to help with health insurance costs.

• **Employer responsibilities.** After Dec. 31, 2013, any “applicable large employer” (generally, one that employed an average of at least 50 full-time employees during the preceding calendar year) not offering coverage during any month for all its full-time employees, offering “minimum essential coverage” that is unaffordable, or offering “minimum essential coverage” that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60%:

- will have to pay a penalty if any full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

- The penalty for any month will be an excise tax equal to the number of full-time employees over a 30-employee threshold during the applicable month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by one-twelfth of \$2,000 (adjusted for inflation after 2014).

- For any month that an “applicable large employer” offers its full-time employees and their dependents the opportunity to enroll in “minimum essential coverage” under an employer sponsored plan and any full-time employee is certified to the employer as having enrolled in health insurance coverage purchased through a State Exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to such employee or employee, such “applicable large employer” will be subject to a penalty imposed under IRC §4980H.

- **Free choice vouchers.** After Dec. 31, 2013, employers offering minimum essential coverage through an eligible employer-sponsored plan and paying a portion of that coverage will have to provide “qualified employees” with a voucher

Baringer
Advance Tax Issues

whose value can be applied to purchase of a health plan through the Insurance Exchange.

- **“Qualified employees”** are those employees:

- who do not participate in the employer's health plan;
- whose required contribution for employer sponsored “minimum essential coverage” (if they did participate in the plan) exceeds 8%, but does not exceed 9.8% of household income; and
- whose total household income does not exceed 400% of the poverty line for the family.

- After 2014, the 8% and 9.8% will be indexed for premium growth.

- The value of the voucher is equal to the dollar value of the employer contribution to the employer offered health plan and is not includable in income to the extent it is used for the purchase of health plan coverage. If the value of the voucher exceeds the premium of the health plan chosen by the employee, the employee is paid the excess value of the voucher. The excess amount received by the employee is includible in gross income.

- If an individual receives a voucher, he is disqualified from receiving any tax credit or cost sharing credit for the purchase of a plan in the Insurance Exchange. Similarly, under IRC §139D, if any employee receives a free choice voucher, the employer is not assessed a shared responsibility payment on behalf of that employee.

- **Tax credits for small employers offering health coverage.** For tax years beginning after Dec. 31, 2009, “eligible small employers” will be given a tax credit for nonelective contributions to purchase health insurance for their employees.

- An **“eligible small employer”** generally is an employer with no more than 25 “full-time equivalent employees” (“FTE employees”) employed during the employer's tax year, and whose employees have annual “full-time equivalent wages” that average no more than

Baringer
Advance Tax Issues

\$50,000. However, the full amount of the credit is available only to an employer with 10 or fewer FTE employees and whose employees have average annual fulltime equivalent wages from the employer of less than \$25,000. These wage limits will be indexed to the Consumer Price Index for Urban Consumers ("CPI-U") for years beginning in 2014.

- For tax years beginning in 2010 through 2013, the credit under IRC §45R will be 35% (25% for certain tax-exempts) for small employers with fewer than 25 employees and average annual wages of less than \$50,000 who offer health insurance coverage to their employees.

- In 2014 and subsequent years, “eligible small employers” who purchase coverage through the Insurance Exchange will be eligible for a tax credit under IRC §45R for two years of up to 50% (35% for certain tax exempts) of their contribution.

- **Dependent coverage in employer health plans.** Amendments to IRC §§ 105, 162, 401 and 501, effective as of the enactment date of the Reconciliation Act, extend the general exclusion for reimbursements for medical care expenses under an employer-provided accident or health plan to the cost of coverage for any child of an employee who has not attained age 27 as of the end of the tax year. Self-employed individuals may take a deduction for any child of the taxpayer who has not attained age 27 as of the end of the tax year.

- **Health-Related Revenue Raising Provisions of the New Law**

- **Excise tax on high-cost employer-sponsored health coverage.** For tax years beginning after Dec. 31, 2017, a 40% nondeductible excise tax will be levied on insurance companies and plan administrators for any health coverage plan to the extent that the annual premium exceeds \$10,200 for single coverage and \$27,500 for family coverage (so-called “Cadillac Plans”). An additional threshold amount of \$1,650 for single coverage and \$3,450 for family coverage will apply for retired individuals age 55 and older and for plans that cover employees engaged in high risk professions.

- The tax will apply to self-insured plans and plans sold in the group market, but not to plans sold in the individual market (except for coverage eligible for the deduction for self-employed individuals).

- Stand-alone dental and vision plans will be disregarded in

Baringer
Advance Tax Issues

applying the tax. The dollar amount thresholds will be automatically increased if the inflation rate for group medical premiums between 2010 and 2018 is higher than the Congressional Budget Office (CBO) estimates in 2010.

- Employers with age and gender demographics that result in higher premiums could value the coverage provided to employees using the rates that will apply using a national risk pool.

- Under IRC §4980I, the excise tax will be levied at the insurer level. Employers will be required to aggregate the coverage subject to the limit and issue information returns for insurers indicating the amount subject to the excise tax.

• **Cost of employer sponsored health coverage included on Form W-2.** Under amendments to IRC §6501(a)(14), for tax years beginning after Dec. 31, 2010, employers must disclose the value of the benefit provided by them for each employee's health insurance coverage on the employee's annual Form W-2. This is for information reporting only, and does not mean that the value of these benefits is to be included in taxable income, contrary to what has been indicated in numerous emails circulating around the country.

• **Other new employer reporting responsibilities for health coverage.** For periods beginning after 2013, under new IRC §6056 and amended IRC §6724, insurers (including employers who self-insure) that provide “minimum essential coverage” to any individual during a calendar year must report the following to both the covered individual and to IRS:

(1) name, address, and taxpayer identification number (TIN) of the primary insured, and name and TIN of each other individual obtaining coverage under the policy;

(2) the dates during which the individual was covered under the policy during the calendar year;

(3) whether the coverage is a qualified health plan offered through an exchange;

(4) the amount of any premium tax credit or cost-sharing reduction received by the individual with respect to such coverage; and

(5) such other information as IRS may require.

- To the extent coverage is through an employer-provided group health plan, the insurer is also required to report the name, address and employer identification number of the employer, the portion of the premium, if any, required to be paid by the employer, and any other information IRS may require to administer the new tax credit for eligible small employers.

• **Additional Payroll & Self-Employment Hospital Insurance Tax (HI) Component for high wage workers.** Under IRC §§1401 and 3101, for tax years beginning after Dec. 31, 2012, the HI tax rate is increased by 0.9 percentage points on an individual taxpayer earning over \$200,000 (\$250,000 for married couples filing jointly); these figures are not indexed.

• **Unearned Income Medicare Contribution.** Under new IRC §1411, for tax years beginning after Dec. 31, 2012, a 3.8% surtax (called the “Unearned Income Medicare Contribution”) will apply to net investment income of higher income taxpayers. The surtax for individuals is 3.8% of the lesser of (1) net investment income or (2) the excess of modified adjusted gross income (AGI) over the threshold amount. The threshold amount is \$250,000 for a joint return or surviving spouse, \$125,000 for a married individual filing a separate return, and \$200,000 in any other case. Modified AGI is AGI increased by the amount excluded from income as foreign earned income under IRC §911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

- For an estate or trust, the surtax is 3.8% of the lesser of: (1) undistributed net investment income or (2) the excess of AGI (as defined in IRC §67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

- The tax does not apply to a nonresident alien or to a trust all the unexpired interests in which are devoted to charitable purposes, a trust that is exempt from tax under IRC §501, or a charitable remainder trust exempt from tax under IRC §664.

- The surtax is subject to the individual estimated tax provisions and is not deductible in computing any tax imposed by subtitle A of the Code (relating to income taxes).

- Net investment income for surtax purposes is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). Investment income is reduced by properly allocable deductions to such income to arrive

Baringer
Advance Tax Issues

at net investment income.

- **New limit on health FSA contributions.** Under amendments to IRC §125, for tax years beginning after Dec. 31, 2012, the amount of contributions to health flexible spending accounts (FSAs) under cafeteria plans will be limited to \$2,500 per year. The dollar amount will be inflation indexed after 2013.

- **Restricted definition of medical expenses for employer provided coverage.** Under amendments to IRC §§106(f), 220(d)(2), and 223(d)(2), for purposes of employer provided health coverage (including health reimbursement accounts (“HRAs”) and health flexible savings accounts (“FSAs”), health savings accounts (“HSAs”), and Archer medical savings accounts (“MSAs”)), the definition of medicine expenses deductible as a medical expense is generally conformed to the definition for purposes of the itemized deduction for medical expenses. But this change does not apply to doctor prescribed over-the-counter medicine.

- Thus, the cost of over-the-counter medicine (other than insulin or doctor prescribed medicine) cannot be reimbursed through a health FSA or HRA.

- In addition, the cost of over-the-counter medicines (other than insulin or doctor prescribed medicine) cannot be reimbursed on a tax-free basis through an HSA or Archer MSA.

- These changes for HSAs and Archer MSAs apply for amounts paid out with respect to tax years beginning after Dec. 31, 2010. The changes for health FSAs and HRAs apply for reimbursement of expenses incurred with respect to tax years beginning after Dec. 31, 2010.

- **Increased tax on nonqualifying HSA or Archer MSA distributions.** Under amendments to IRC §§220(f)(4)(A) and 223(f)(4)(A), for distributions made after Dec. 31, 2010, the additional tax for HSA withdrawals before age 65 that are used for purposes other than qualified medical expenses is increased from 10% to 20%, and the additional tax for Archer MSA withdrawals that are used for purposes other than qualified medical expenses is increased from 15% to 20%.

- **Modified threshold for claiming medical expense deductions.** Under amendments to IRC §§56(b)(1)(B), 213(a) and 213(f), for tax years beginning after Dec. 31, 2012, the adjusted gross income (AGI) threshold for claiming the itemized deduction for medical expenses will be increased from 7.5% to 10%. However, the 7.5%-of-AGI threshold will continue to apply through 2016 to individuals age 65 and older (and their spouses).

Baringer
Advance Tax Issues

- **Deduction for employer Part D is eliminated.** Under the new law, for tax years beginning after Dec. 31, 2012, the deduction for the subsidy for employers who maintain prescription drug plans for their Medicare Part D eligible retirees will be eliminated.
- **Health Care Industry-Specific Revenue Raisers.** The following revenue raising changes will be imposed on health related industries:
 - **A new deduction limit on executive compensation applies to insurance providers.** Under amendments to IRC §162(m)(6), if at least 25% of the insurance provider's gross premium income is derived from health insurance plans that meet the “minimum essential coverage” requirements in the new health reform law (a “covered health insurance provider”), an annual \$500,000 per tax year compensation deduction limit will apply for all officers, employees, directors, and other workers or service providers performing services for or on behalf of a covered health insurance provider. The limit applies to remuneration paid in tax years beginning after 2012 for services performed after 2009.
 - **Pharmaceutical manufacturers and importers will have to pay an annual flat fee beginning in 2011 allocated across the industry according to market share.** Under the new law, the annual flat fee beginning in 2011 is allocated across the industry according to market share. The schedule for the flat fee is: 2011, \$2.5 billion; 2012 to 2013, \$2.8 billion; 2014 to 2016, \$3 billion; 2017, \$4 billion; 2018, \$4.1 billion; 2019 and later, \$2.8 billion. The fee will not apply to companies with sales of branded pharmaceuticals of \$5 million or less.
 - **For sales after Dec. 31, 2012, new IRC §4191 imposes on manufacturers or importers of medical devices an excise tax of 2.3% of the sale price, which is imposed on the sale of any taxable medical device by the manufacturer, producer, or importer of the device.** A taxable medical device is any device, defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act, intended for humans. The excise tax will not apply to eyeglasses, contact lenses, hearing aids, and any other medical device determined by the IRS to be of a type that is generally purchased by the general public at retail for individual use.
 - **Health insurance providers will face an annual flat fee on the**

Baringer
Advance Tax Issues

health insurance sector effective for calendar years beginning after Dec. 31, 2013. The fee will be allocated based on market share of net premiums written for a U.S. health risk for calendar years beginning after Dec. 31, 2012.

- The aggregate annual flat fee for the industry will be: \$8 billion for 2014; \$11.3 billion for 2015 and 2016; \$13.9 billion for 2017; and \$14.3 billion for 2018.
- The fee will be indexed to the rate of premium growth for later years.
- The fee will not apply to companies whose net premiums written are \$25 million or less.

• **Under new IRC §5000B, the indoor tanning industry is subject to a 10% excise tax on indoor tanning services after July 1, 2010.**

• **Under amended IRC §833(c)(5), for tax years beginning after Dec. 31, 2009, nonprofit Blue Cross Blue Shield organizations must maintain a medical loss ratio of 85% or higher in order to take advantage of the special tax benefits provided to them, including the deduction for 25% of claims and expenses and the 100% deduction for unearned premium reserves.**

• **Corporate information reporting.** Under amended IRC §6041(h), for payments made after Dec. 31, 2011, businesses that pay any amount greater than \$600 during the year to corporate providers of property and services will have to file an information report with each provider and with the IRS.

• **Codification of economic substance doctrine and imposition of penalties.** The economic substance doctrine is a judicial doctrine that has been used by the courts to deny tax benefits when the transaction generating these tax benefits lacks economic substance. The courts have not applied the economic substance doctrine uniformly. Under IRC §§6662, 6662A, 6664, 6676, and 7701, as amended by the Reconciliation Act, for transactions entered into after the enactment date of the Reconciliation Act, and to underpayments, understatements, and refunds and credits attributable to transactions entered into after the enactment date of the Reconciliation Act, the manner in which the economic substance doctrine should be applied by the courts is clarified and a penalty is imposed on understatements attributable to a transaction lacking economic substance.

• **Elimination of tax credit for black liquor.** A \$1.01 per gallon tax credit applies for the production of biofuel from cellulosic feedstocks in order to encourage the

Baringer
Advance Tax Issues

development of new production capacity for biofuels that are not derived from food source materials. Congress is aware that some taxpayers are seeking to claim the cellulosic biofuel tax credit for unprocessed fuels, such as “black liquor.” Under amendments to IRC §40, for fuel sold or used after Dec. 31, 2009, eligibility for the tax credit under the Reconciliation Act will be limited to processed fuels (i.e., fuels that could be used in a car engine or in a home heating application).

- **Estimated taxes for large corporations.** Under amendments to IRC §6655, the required corporate estimated tax payments factor for corporations with assets of at least \$1 billion will be increased by 15.75 percentage points for payments due in July, August, and September of 2014.

- **Other Tax Changes**

- **Simple cafeteria plans for small businesses.** Under amendments to IRC §125(j), for years beginning after 2010, a new employee benefit cafeteria plan known as a “Simple Cafeteria Plan” will be available. This plan will be subject to eased participation restrictions so that small businesses can provide tax-free benefits to their employees; it will include self-employed individuals as qualified employees.

- **Liberalized adoption credit and adoption assistance rules.** Under amendments to IRC §§36C and 137, for tax years beginning after Dec. 31, 2009, the adoption tax credit is increased by \$1,000, and made refundable. The adoption assistance exclusion also is increased by \$1,000. Both the credit and the exclusion are extended through 2011.

- **New credit for new therapies.** Under new IRC §48D, for expenses paid or incurred after Dec. 31, 2008, in tax years beginning after that date, a two-year temporary credit applies, subject to an overall cap of \$1 billion, to encourage investments in new therapies to prevent, diagnose, and treat acute and chronic diseases.

- **New exclusion for certain health professionals.** Under amendments to IRC §108(f), payments made under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas are excluded from gross income, effective for amounts received by an individual in tax years beginning after Dec. 31, 2008. Under new IRC §139D, gross income excludes the value of specified Indian tribal health benefits, effective for benefits and coverage provided after Mar. 23, 2010.

- (b) **Small Business Jobs Act of 2010:**

On September 27, 2010, the President signed into law H.R. 5297, entitled the “Small

Baringer
Advance Tax Issues

Business Jobs Act of 2010". The new law provides a number of important tax provisions which affect large and small businesses, as well as individuals.

Enhanced small business expensing (Section 179 expensing)

Prior to the enactment of this new law, a small business taxpayer was allowed to expense, under I.R.C. §179, up to \$250,000, in qualifying property, in a tax year beginning in 2008 through 2010. This qualifying property includes tangible personal property purchased for use in the active conduct of a trade or business, including "off-the-shelf" computer software placed in service in tax years beginning before 2010. If the cost of all qualifying equipment, placed into service in any given year, exceeded \$800,000 (the investment ceiling) then the \$250,000 maximum expensing amount was reduced dollar for dollar (but not below zero) by that amount.

Under the new law, for tax years beginning in 2010 and 2011, the \$250,000 limit is increased to \$500,000 and the investment ceiling to \$2,000,000. Furthermore, the new law also makes certain real property eligible for expensing by treating such property as I.R.C. §179 property. For the tax years beginning in 2010 and 2011, the up to \$500,000 of property expenses allowed can include up to \$250,000 of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).

It should be noted, however, that this higher allowance granted for the tax years of 2010 and 2011 do not come without a price. The allowance amounts will be drastically reduced, below 2010 limits, starting in 2012. For tax years beginning after 2011, there will be a \$25,000 dollar limit on expensing and a \$200,000 investment ceiling.

The Bonus first-year depreciation is extended through 2010

I.R.C. §168(k), allows a taxpayer to make a 50% bonus depreciation allowance in the year qualified property is placed into service. This 50% bonus depreciation allowance only applied to qualified property placed into service after December 31, 2007 and before January 1, 2010. The new law extends the 50% bonus first-year depreciation for one extra year by making it available for qualifying property acquired and placed in service in 2010 as well.

The first-year depreciation cap for 2010 autos and trucks boosted by \$8,000

I.R.C. §280(F) allows a taxpayer to make an initial depreciation deduction of specified amounts for passenger automobiles placed into service during the tax year. The amount varies depending on the type (and weight) of the vehicle and is adjusted for inflation. The new law boost this depreciation deduction by \$8,000 for any passenger automobile that is "qualified property" and which is not subject to a taxpayer election to decline the 50% bonus depreciation.

Special long-term contract accounting rule for bonus depreciation on certain

Baringer
Advance Tax Issues

property placed in service after 2009

For property placed in service after December 31, 2009, the new law provides that solely for purposes of determining the percentage of completion under I.R.C. §460(b)(1)(A), the cost of qualified property is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted.

The deduction for startup expenses increased

Prior to the enactment of this new law, a taxpayer could elect to deduct up to \$5,000 of start-up expenditures in the tax year in which the active trade or business began. This amount, however, was reduced (but not below zero) by the amount by which the cumulative cost of start-up expenditures exceeded \$50,000. The remainder of the start-up expenditures could be claimed as a deduction ratable over 180 months starting with the month the active trade or business began.

Under the new law, for tax years beginning after December 31, 2009, and before January 1, 2011, the \$5,000 amount for start-up expenditures is increased to \$10,000, and the phaseout threshold is increased from \$50,000 to \$60,000.

Five-year carryback for eligible small business credits

Prior to the enactment of this new law, a business's unused general business credits could be carried back to offset taxes paid in the previous year, and the remaining amount could be carried forward for up to 20 years to offset future tax liabilities. Under the new law, for the first tax year of the taxpayer beginning in 2010, eligible small businesses can carry back unused general business credits for five years. Eligible small businesses consist of sole proprietorships, partnerships and non-publicly traded corporations with \$50 million or less in average annual gross receipts for the prior three years.

Eligible small businesses may offset AMT with general business credits in the 2010 tax year

I.R.C. §38(c)(1) provides that the general business credit (GBC) is limited to the excess, if any, of the taxpayer's "net income tax" (generally, the taxpayer's regular income tax and alternative minimum tax (AMT), reduced by most non-refundable credits other than the GBC) over the greater of (1) the taxpayer's tentative minimum tax for the tax year, or (2) 25% of the portion of the taxpayer's "net regular tax liability" (generally, the regular income tax reduced by most non-refundable credits other than the general business credit) that exceeds \$25,000.

The New law provides that for eligible small business (ESB) credits, determined in tax years beginning in 2010, the Act allows ESB credits to offset AMT liability and increases the extent to which ESB credits can offset regular tax liability.

Baringer
Advance Tax Issues

100% exclusion of gain from the sale of small business stock for qualifying stock acquired after September 27, 2010 and before January 1, 2011

Before the 2009 Recovery Act, individuals could exclude 50% of their gain on the sale of qualified small business stock (QSBS) held for at least five years (60% for certain empowerment zone businesses). To qualify, QSBS must meet a number of conditions (e.g., it must be stock of a corporation that has gross assets that do not exceed \$50 million, and the corporation must meet active business requirements). Under the 2009 Recovery Act, the percentage exclusion for gain on QSBS sold by an individual was increased to 75% for stock acquired after February 17, 2009 and before January 1, 2011. Under the new law, the amount of the exclusion is temporarily increased yet again, to 100% of the gain from the sale of qualifying small business stock that is acquired in 2010 after September 27, 2010 and held for more than five years. In addition, the new law eliminates the alternative minimum tax (AMT) preference item attributable for that sale.

S corporation holding period for appreciated assets shortened to five years

Generally, a C corporation converting to an S corporation must hold onto any appreciated assets for 10 years or face a built-in gain tax at the highest corporate rate of 35%. The 2010 Small Business Jobs Act temporarily shortens the holding period of assets subject to the built-in gains tax to 5 years if the 5th tax year in the holding period precedes the tax year beginning in 2011.

Penalty for failure to report shelter transactions

I.R.C. §6707(A) imposes a penalty on any person who fails to include on any return or statement any information regarding a “reportable transaction” which is required to be included with the return or statement. Reportable transactions are those identified by the IRS as having a potential for tax avoidance or evasion. Prior to the enactment of the new law, the penalty for failure to report a reportable transaction was \$10,000 in the case of a natural person and \$50,000 for others (\$100,000 and \$200,000 respectively for listed transactions).

Under the new law, for penalties assessed after December 31, 2006, the amount of the penalty with respect to any reportable transaction is 75% of the decrease in tax shown on the return as a result of the transaction (or which would have resulted from the transaction if it were respected for federal tax purposes. The amount of the penalty for any reportable transaction for any tax year cannot exceed: (1) for a listed transaction, \$200,000 (\$100,000 in the case of a natural person); and (2) for any other reportable transaction, \$50,000 (\$10,000 in the case of a natural person).

Deductibility of health insurance for the purpose of calculating self-employment tax

The new law allows business owners to deduct the cost of health insurance incurred in 2010 for themselves and their family members in calculating their 2010 self-employment tax. A

Baringer
Advance Tax Issues

self-employed individual can deduct as a trade or business expense the amount paid during the tax year for health insurance for the taxpayer; the taxpayer's spouse; the taxpayer's dependents; and, effective March 30, 2010, any child of the taxpayer who has not attained age 27 as of the end of the tax year. I.R.C. §162(1)(4).

Cell phones removed from listed property category

Under the new law, for tax years beginning after December 31, 2009, cellular telephones and other similar telecommunications equipment have been removed from the categories of "listed property" under I.R.C. §280(F). Thus, the heightened substantiation requirements and special depreciation rules that apply to listed property do not apply to cell phones.

Partial annuitization of nonqualified annuity allowed after 2010

Amounts "received as an annuity" under a life insurance, endowment, or annuity contract are includible in gross income, unless an exception is available. The payment may be over a specific period or during one or more lives. Under the annuity rule, a portion of each payment received is excluded based on an exclusion ratio (the investment in the contract divided by the expected return). The excludable amount of each payment is computed by multiplying it by the exclusion ratio. The investment in the contract is determined as of the annuity starting date.

Under the new law, for amounts received in tax years beginning after December 31, 2010, the Act adds a new rule that will allow the partial annuitization of a nonqualified annuity, endowment, or life insurance contract. See I.R.C. §72(a)(2), as amended by Act Sec. 2113(a).

Participants in governmental 457 plans allowed to treat elective deferrals as Roth contributions

For tax years beginning after December 31, 2010, the new law will allow retirement savings plans sponsored by state and local governments (governmental 457(b) plans) to include designated Roth accounts. Contributions to Roth accounts are made on an after-tax basis, but distributions of both principal and earnings are generally tax-free.

Allow rollovers from elective deferral plans to designated Roth accounts

The new law allows 401(k), 403(b), and governmental 457(b) plans to permit participants to roll their pre-tax account balances into a designated Roth account. The amount of the rollover will be includible in taxable income except to the extent it is the return of after-tax contributions. If the rollover is made in 2010, the participant can elect to pay the tax in 2011 and 2012. Plans will be able to allow these rollovers immediately as of September 27, 2010.

Information reporting required for rental property expense payments

Baringer
Advance Tax Issues

For payments made after December 31, 2010, the new law requires persons receiving rental income from real property to file information returns with the IRS and service providers reporting payments of \$600.00 or more during the tax year for rental property expenses. Exceptions are provided for individuals renting their principal residences on a temporary basis (including active members of the military), taxpayers whose rental income does not exceed an IRS-determined minimal amount, and those for whom the reporting requirement would create a hardship (under IRS regulations).

Informational return penalties increased

I.R.C. §6721 imposes penalties for failing to provide timely, complete, and correct information returns. Prior to the enactment of the new law, if a person did not file a correct information return on or before August 1 of the calendar year in which the required filing date occurred, the amount of the penalty was \$50 per return (third-tier penalty), with a maximum penalty of \$250,000 per calendar year. If a person filed a correct information return after the prescribed filing date but on or before the date that was 30 days after the prescribed filing date, the amount of the penalty was \$15 per return (first-tier penalty), with a maximum penalty of \$75,000 per calendar year. If a person filed a correct information return after the date that was 30 days after the prescribed filing date but on or before August 1 of the calendar year in which the required filing date occurred, the amount of the penalty was \$30 per return (second-tier penalty), with a maximum penalty of \$150,000 per calendar year.

Under the new law, for information returns required to be filed after December 31, 2010, the Act increases the third-tier penalty from \$50 to \$100 and increases the calendar year maximum limit on it from \$250,000 to \$1,500,000. The new law increases the first-tier penalty from \$15 to \$30 and increases the calendar year maximum limit on it from \$75,000 to \$250,000. The new law increases the second-tier penalty from \$30 to \$60 and increases the calendar year maximum limit on it from \$150,000 to \$500,000. For small businesses (firms having average annual gross receipts for the most recent three tax years that do not exceed \$5 million, the calendar year maximum is increased from \$100,000 to \$500,000 for the third-tier penalty, from \$25,000 to \$75,000 for the first-tier penalty, and from \$50,000 to \$200,000 for the second-tier penalty.

Increases per statement rates and maximum and minimum payee statement penalty

I.R.C. §6722 imposes penalties for (a) and failure to furnish a payee statement to the person prescribed, on or before the date prescribed, and (b) any failure to include all the information required to be shown on the payee statement or any inclusion of incorrect information on the payee statement.

Under the new law, for information returns required to be filed after December 31, 2010, the basic penalty is increased from \$50 to \$100 and the calendar year maximum limit on it is

Baringer
Advance Tax Issues

increased from \$100,000 to \$1,500,000. The new law revises the penalty for failure to furnish a payee statement to provide tiers and caps similar to those applicable to the penalty for failure to file the information return.

The new law reduces the penalty for failures corrected on or before the day 30 days after the required filing date. In such cases, the basic penalty is reduced from \$100 to \$30 (first-tier penalty). The calendar year maximum limit per person for all such correct failures is \$250,000.

The new law also provides for a less significant reduction if a failure subject to the penalty is corrected after the 30-day deadline, but on or before August 1 of the calendar year in which the required filing date occurred. In such a case, the basic penalty is reduced from \$100 to \$60 (second-tier penalty). The calendar year maximum limit per person for all such corrected failures is \$500,000.

Under the new law, the maximum penalties for small businesses are \$500,000, rather than \$1,500,000 if the failures are not corrected on or before August 1 of the calendar year in which the required filing date occurred, \$75,000 rather than \$250,000 if the failures are corrected on or before 30 days after the prescribed filing date, and \$200,000 rather than \$500,000 if the failures are corrected on or before August 1.

New rules set out how to source guarantee income

For guarantees issued after September 27, 2010, the new law provides specific sourcing rules for guarantee fees and legislatively overrules the result in *Container Corp.* (Committee Report). Under the new law, gross income from sources within the U.S. includes amounts received, directly or indirectly, from:

- (1) a noncorporate resident or domestic corporation for the provision of a guarantee of any indebtedness of that resident or corporation; or
 - (2) any foreign person for the provision of a guarantee of any indebtedness of such person, if those amounts are connected with income that is effectively connected (or treated as effectively connected) with the conduct of a U.S. trade or business.
- I.R.C. §861(a)(9).

Any amounts received, directly or indirectly, from a foreign person for the provision of a guarantee of indebtedness of that person, other than amounts derived from sources within the U.S. described in I.R.C. §861(a)(9) are treated as income from foreign sources. I.R.C. §862(a)(9).

No pre-levy CDP hearing required for certain federal contractors

For levies issued after September 27, 2010, the new law provides that the IRS will not have to hold a pre-levy “Collection Due Process” (CDP) hearing if the IRS has served a “federal

Baringer
Advance Tax Issues

contractor levy.” I.R.C. §6330. A federal contractor levy is any levy if the person subject to the levy (or any predecessor of that person) is a federal contractor. I.R.C. §6330(h)(2). Thus, the IRS will be allowed to issue levies before a CDP hearing for federal taxes owned by federal contractors identified under the Federal Payment Levy Program (FPLP)-an automated levy program that was developed to administer continuous levies under which no paper levy documents are served. When a levy is issued before a CDP hearing, the taxpayer will have an opportunity for a CDP hearing within a reasonable time after the levy.

Accelerated 2015 estimated tax payment for large (\$1 billion) corporations

Generally, corporations are required to pay estimated income tax for each tax year in 4 equal installments due on the 15th day of the 4th, 6th, 9th, and 12th month of the tax year. However, prior to the enactment of the new law, in the case of a corporation with assets of at least \$1 billion (determined as of the end of the previous tax year), the amount of any required installment of corporate estimated tax that would otherwise be due in July, August, or September 2015 was 123.25% of that amount. The amount of the next required installment after an increased installment must be appropriately reduced to reflect the amount of the increase.

The new law provides that the percentage under the 2010 Hiring Incentives to Restore Employment (HIRE) Act § 561(2) in effect on September 27, 2010 is increased by 36 percentage points. Thus, the new law increases the required payment of corporate estimated tax otherwise due in July, August, or September 2015 by 36 percentage points.

(c) Expiring Bush Tax Cuts & AMT Expansion from Lack of Indexing

We are in the midst of times within which the largest tax hikes in the history of America will take effect. The following is a general summary of just a few of the most significant affects of these sunset provisions:

Expiration of 2001 and 2003 Tax Relief

In 2001 and 2003, Congress enacted several tax cuts for investors, small business owners, and families. These will all expire on January 1, 2011:

Personal income tax rates will rise. The top income tax rate will rise from 35 to 39.6 percent (this is also the rate at which two-thirds of small business profits are taxed). The lowest rate will rise from 10 to 15 percent. All the rates in between will also rise. Itemized deductions and personal exemptions will again phase out, which has the same mathematical effect as higher marginal tax rates. The full list of marginal rate hikes is below:

-The 10% bracket rises to an expanded 15%

Baringer
Advance Tax Issues

- The 25% bracket rises to 28%
- The 28% bracket rises to 31%
- The 33% bracket rises to 36%
- The 35% bracket rises to 39.6%

Higher taxes on marriage and family. The “marriage penalty” (narrower tax brackets for married couples) will return from the first dollar of income. The child tax credit will be cut in half from \$1000 to \$500 per child. The standard deduction will no longer be doubled for married couples relative to the single level. The dependent care and adoption tax credits will be cut.

The Return of the Death Tax. This year, there is no death tax. For those dying on or after January 1, 2011, there is a 55 percent top death tax rate on estates over \$1 million. A person leaving behind two homes and a retirement account could easily pass along a death tax bill to their loved ones.

Higher tax rates on savers and investors. The capital gains tax will rise from 15 percent this year to 20 percent in 2011. The dividends tax will rise from 15 percent this year to 39.6 percent in 2011. These rates will rise another 3.8 percent in 2013.

The AMT will ensnare over 28 million families, up from 4 million last year. According to the left-leaning Tax Policy Center, Congress’ failure to index the AMT will lead to an explosion of AMT taxpaying families—rising from 4 million last year to 28.5 million. These families will have to calculate their tax burdens twice, and pay taxes at the higher level. The AMT was created in 1969 to ensnare a handful of taxpayers, but the failure to index the AMT to be adjusted by annual inflation has resulted in many more taxpayers than was ever intended being subjected to the AMT.