



So You Want Your LLC to Be An S Corporation...
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LLCs and S Corporation Status

This week's podcast deals with a topic that was suggested by an email I received from an listener to the podcast, and relates to an issue that has arisen a couple of times on the Arizona Society of CPA's listserve related to the issues that arise with LLCs that wish to be treated as an S corporation. It's an issue often not covered in depth in CPE courses—and I'll admit that true of courses I do. The issue is that LLCs tend to be covered in partnership courses, while S corporation courses tend to concentrate on corporate forms. So the LLC as an S corporation tends to become an issue dealt with in passing in either course.

However, there are cases where this is an option that should be considered, and there are gotchas that have to be considered in order to insure that you end up with the desired result.

The Incredible Missing Entity

The regulations under §7701 govern the tax classification of entities for federal income tax purposes, and these definitions have to fit the items described in the Internal Revenue Code. While the IRC talks about corporations, partnerships, trusts and estates, it never mentions the thing known as a “limited liability company” or LLC. That’s not an accident.

LLCs first appeared in Wyoming in the 1970s, and they were designed specifically to be an entity that wasn’t one of those described in the Internal Code. They were meant to allow the use of an entity that limited the liability of all owners, allowed full participation in management by any or all owners, and still gave us the ability to flow through income and use special allocations. While limited partnerships, other partnerships and corporations could have given us some of those features, none could have given us all of those features in the same entity—but LLCs were meant to do that.

The fact LLCs weren’t specifically defined in the IRC doesn’t mean the entity didn’t have a tax responsibility—rather, it meant that for federal tax purposes it was going to be classified as one of the things the IRC does define. Before “check the box” we had the exercise of deciding if our LLC had “too many” corporate features and was going to be taxed as a corporation, or whether it could maintain partnership tax treatment. But what it was for federal tax purposes, that was the treatment of the entity for all federal tax purposes.¹

So if your LLC was a corporation, it had exactly the same standing as a entity that was formed as a corporation under state law. So, for instance (and the subject of today’s podcast), the entity could elect S status so long as it met the other requirements of electing S status besides the basic one of being a corporation for tax purposes. Check the box simplified our classification issues, but it didn’t change the fact that once the classification is determined, the entity is taxed the same as any other legal entity that is treated as the same type of tax entity.

What check the box did do, though, was allow us to pick and choose which type of entity we wanted our LLC to be treated as rather than having it go through a sieve of attributes that then placed it into a single box. Generally, LLCs have two options—a default (which is based on how many owners it has) or electing to be

¹ OK, actually that overstates things a bit. If the fact the entity is an LLC has a nontax impact, that can “spill over” to the tax treatment. For instance, the fact that the LLC limits the liability of the members can cause tax issues, but that’s related to the fact that we have debt for which the member is not liable—and the same problems would arise in a traditional partnership if you have a debt the partner isn’t liable for.

treated as a corporation.²

Many CPAs I hear discuss LLCs seem to miss this point, mechanically equating LLCs with partnerships, or still attempting to apply partnership taxation concepts to LLCs that either have only a single member or which have elected corporate treatment. Federal tax law simply doesn't work that way—rather, once we've got the entity classified we ignore the fact that it may be organized under the state LLC statute. Arizona law (and most other state income tax laws) follow the same treatment. Note that California is one rather major exception among the minority of states that pay some attention to the entity being an LLC for tax purposes.

Checking the Box

Domestic LLCs have a default classification based on the number of owners it has. If the entity has a single owner, it is disregarded as an entity separate from its owner [Reg. §301.7701-3(b)(1)(ii)]. Note that if the entity that owns the LLC is a partnership, that single member LLC would be ignored, and its assets would be treated as owned by the partnership. Similarly, if the owner of the LLC is a corporation, we also ignore the LLC and treat the assets as if owned directly by the corporation.

If the entity has more than one owner, the default treatment is as a partnership [Reg. §301.7701-3(b)(1)(i)].

Election to Take

Either type of entity can elect, instead of its default treatment, to be treated as an "association" [Reg. §301.7701-3(a)] which means a corporation for these purposes (see the definition of a corporation at §7701(a)(3)). The election is made in accordance with the provisions found in Reg. §301.7701-3(c).

Reg. §301.7701-3(c)(1)(i) describes the general rule for how elections are handled. It provides

(c) Elections

(1) Time and place for filing

(i) In general.

Except as provided in paragraphs (c)(1)(iv) and (v) of this

² Note that a foreign LLC may end up with its default treatment being corporate, with an optional election to be treated as a partnership—but that's beyond today's podcast. Just be aware that if you have an LLC formed under the laws of another country, you should strongly consider filing a Form 8832 as a protective measure no matter what classification you want. See Reg. §301.7701(b)(2).

section, an eligible entity may elect to be classified other than as provided under paragraph (b) of this section, or to change its classification, by filing Form 8832, Entity Classification Election, with the service center designated on Form 8832. An election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832. See section 301.6109-1 for rules on applying for and displaying Employer Identification Numbers.

The election is effective as of the date filed unless a different date is specified on the Form 8832—something you would almost always want to do. That specified date can be up to 75 days before the date the election is filed, or 12 months after the date of filing [Reg. §301.7701-3(c)(1)(iii)]. That means that both prospective and retroactive changes are allowed.

Having corporate status, you can elect S if the entity is eligible. Originally that was done by filing a Form 2553 within 75 days of the effective date of your 8832 election—but that created a number of issues. The problem was that the IRS might very well try to process the 2553 before the 8832 was processed, creating a situation where it appeared that a partnership was attempting to elect S status. Since a partnership can't elect S (that's a corporate election), the election would be bounced as invalid. However, the 8832 continued to make its way through the system and eventually was accepted. This resulted in significant correspondence to sort out the situation and eventually convince the IRS computer systems and IRS personnel that there was a timely filed valid S corporation election.

To eliminate that issue, Reg. §301.7701-3(c)(1)(v)(C) provided a short cut election for an entity that wished to both elect to change its status to corporation and then have S treatment for that corporation. That provision provides that:

(C) S corporations.

An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made an election under this section to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b). Subject to § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under § 301.7701-3(c)(1)(i), to be classified as other than an association.

Note that the treatment as an association is conditioned upon being eligible to be treated as an S corporation as of the date of election—so if it turns out the entity was not eligible to be an S corporation, the 8832 election is also invalid per the terms of this regulation.

If, for some reason, the taxpayer wants the corporate election to stand even if it later is found that the corporation was not eligible to be an S corporation, it would appear that the taxpayer would need to file a protective 8832 that would take effect regardless of the initial validity of the S status. However, quite often we would prefer if it turns the entity was not eligible to elect S status that the entity not be deemed to have elected corporate status—since the resulting corporation in that case would be a C corporation.

The taxation of the incorporation is governed by the standard incorporation rules of §351 and often (but not always) goes through with no immediate tax consequence.

S Status and LLCs

As is noted above, entities eligible to be an S corporation are defined at §1361(b). As a general rule, the corporation has to be a domestic corporation and not be an “ineligible corporation” listed below:

- Financial institution using the reserve method of accounting
- Insurance company subject to tax under Subchapter L
- A corporation making an election under §936 (Puerto Rico and possession tax credit)
- A DISC or former DISC [IRC §1361(b)(1)]

Most of the corporations I deal with have no problem meeting those requirements—the real issue comes with four additional requirements imposed on otherwise eligible corporations:

- No more than 100 shareholders
- No ineligible shareholders (shareholders other than individuals, an estate, a limited subset of trusts and certain exempt organizations)
- No nonresident alien shareholder
- No more than one class of stock [IRC §1361(b)(1)]

LLCs pose some special issues for the second and fourth tests.

Some practitioners decide that an LLC can't be an S corporation shareholder by noting that an LLC isn't listed as an eligible shareholder. However, if that LLC is treated as having a single owner and is treated as a disregarded entity, there's not an issue—Reg. §301.7701-3's classification applies for all purposes under

Title 26 and you continue to have an eligible shareholder.

However, partnerships cannot be S corporation shareholders. So that means that if an LLC is an owner of the S corporation stock and any interest in that LLC is transferred to another owner, the available entity classifications for that LLC would no longer leave an eligible shareholder and the S election of any corporation that has any shares outstanding held by that LLC would be terminated.

Note that a community property husband/wife LLC that decided to file a partnership return at some pursuant to Revenue Procedure 2002-69 rather than take the option to be a disregarded entity would trigger this revocation. Of interest in that case is that it would appear the revocation would be retroactive back to the beginning of the year for the partnership return in question. And since Revenue Procedure 2002-69 basically allows the couple to make the partnership election by simply filing a partnership return, it's possible the S corporation could be converted to a C corporation by one of its owners after the original due date of the corporate return.

More broadly, since LLCs can elect to change status and do so retroactively back 75 days, an LLC that held S shares and elected to change status would unilaterally revoke the S election of that corporation. Since actions to revoke S status aren't unheard of in shareholder disputes, this situation should be dealt with in the shareholder agreements, and existing agreements should be reviewed to insure that they deal with this arrangement and aren't solely triggered on a transfer of shares—in any of the cases noted above, there is no transfer as the same entity is the owner of the shares (the LLC).

For the LLC electing S status, the big problem tends to the requirement in §1361(b)(1)(D) that the entity have only one class of stock. Since LLCs don't issue stock you might think you couldn't have a problem—but you clearly can. Regulation §301.7701-3(g)(1)'s deemed treatment provisions make clear that the membership interests become, effectively, the “stock” in the deemed corporation. In effect, membership interests are treated as stock, and we measure the various membership interests held against the tests to determine how many classes of “stock” we have outstanding.

Classes of Stock

Reg. §1.1361-1(l) provides the definitions for what constitutes a single class of stock. The first thing to note is that only stock actually outstanding qualifies—so the fact that we may have the option to issue a second class won't kill the S status. However, that regulation imposes two tests for a single class of stock to be applied to interests outstanding—to be considered a single class of “stock”, the interests must have identical:

- Rights as to distributions *and*
- Rights as to liquidation proceeds [Reg. §1.1361-1(I)(1)]

This is where an LLC operating agreement may run into problems, especially if it was drafted to be operated as a partnership with special allocations that qualified under the regulations for §704. As you should recall, the partnership capital account maintenance require that for allocations to be recognized for partnership taxation purposes, the allocations must affect the capital accounts and those capital accounts have to govern the actual rights of the partners eventually to liquidation proceeds. Thus, by definition, any special allocation provision would create a second class of stock if that provision had been valid for partnership taxation purposes.

As well, recall that such a provision is not effective to reallocate S corporation income. Under §1377(a)'s definition of the shareholder's prorata share of items of income and deduction taxable under §1366(a)(1), the calculation is made on a per share/per day basis. Thus, you cannot allocate income on any basis other than via ownership interest in the S corporation. The fact the entity is an LLC doesn't change this result—and if the LLC operating agreement attempts to change that result, the entity is not eligible to elect S status.

As noted above, if you made the single Form 2553 election to be treated as an S corporation and such a provision was in the LLC and operational as of the date of the election, apparently we just drop back to being partnership. However, if such a provision were to be added to LLC operating agreement after the S election was in place, the result is that we don't have a partnership—rather, we now have a C corporation.

One important point to note, though, is that you can have differences in voting rights [Reg. §1.1361-1(I)(1)]. Thus, you don't have to grant identical rights to govern the entity to all members.

And since this a corporation for all purposes, you no longer look to the rules under the 700 series of the IRC for items such as:

- Guaranteed payments under §707(c)
- Elective adjustments of basis due to transfers of interests under §754

Similarly, the provisions of §1402(a)(1) related to the self-employment income of a partner also do not apply. Interestingly enough, while I often see practitioners who are confused and attempt to apply the 700 series rules to an S electing LLC, they almost always have no problem deciding that the self-employment rules don't reference the partnership rules.

Since the LLC is viewed as a corporation under the IRC once the election is in place, the member is likely going to be deemed an employee if he/she performs services for the LLC and is compensated for such services. Note, as well, that such salary compensation is generally the only way to vary the amounts being received by the shareholders in a ratio other than based on their ownership percentages, but that if such compensation doesn't reasonably relate to their services there may be exposure to the existence of a second class of stock if this is deemed to be

Going Back

What happens if I decide I want to get out and be treated as a partnership or disregarded entity? Reg. §301.7701-3 allows you to do so, and the fact it does causes some practitioners to miss an extremely important point about doing so.

You can change your status election so long as you have not made a change within the prior 60 months or, if you have done so, you get IRS permission for the change within the 60 month period [Reg. §301.7701-3(c)(1)(iv)]. However, don't skip by this one too quickly—nowhere in that paragraph of regulation will you find any statement that you can do so in a tax free manner. Rather, you have to keep on reading the regulation down to §Reg. §301.7701-3(g) where you will find some not so wonderful news about the treatment of this transaction.

The entity has multiple owners, the change of entity is governed by Reg. §301.7701-3(g)(1)(ii) which provides:

(ii) Association to partnership.

If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

The liquidation would be governed by the corporate provisions for liquidation of an entity. The big problem is that the corporation would recognize gain on the distribution of property based on the fair value of property distributed [§311(b)]. Note there's no exception for gain that existed on the date the property was transferred from the members to the entity on the deemed incorporation subject to §351, and that such property includes goodwill and other intangible assets deemed owned by the corporation.

Things aren't any better for the single owner LLC/S Corporation. Going to a disregarded entity is governed by Reg. §301.7701-3(g)(1)(iii) with the same results:

(iii) Association to disregarded entity.

If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

Again we have the same triggering of gain, even if that gain resulted from appreciation resulting prior to the initial deemed incorporation transaction.

In both cases, the shareholders could also trigger their own gain recognition on the liquidation, as you would compare the fair value of what they received against their stock basis. However, unlike the C corporation, the shareholders will get an addition to the basis for any gain triggered at the corporate level, so only a single level of tax will apply overall—but that may not be of much consolation to a client that remembers getting into the S status without having to write checks to the IRS and state revenue departments.