# A COMPARISON OF THE ADVANTAGES OF FORMING A LIMITED LIABILITY COMPANY VERSUS AN S CORPORATION

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## I. INTRODUCTION

At one time investors in a business could choose either 1) to be sole proprietors or partners in an entity thus bearing unlimited liability for the losses of that entity or 2) to form a C corporation and be subject to taxation of corporate income at the corporate level and taxation of that portion of remaining income paid to equity holders as a dividend.[1] Then Congress created the S corporation classification for small business entities.[2] Making an S corporation election permits equity holders to pass corporate income through to shareholders without taxation at the corporate level, eliminating the second level of taxation, while still limiting equity holder liability to the money invested in (or lent to) the equity holder. The price for forming an S corporation is a set of rules governing ownership requirements, types of equity and debt permitted, and how gains and losses will be distributed among shareholders. The limited liability company (LLC) was developed in the 1990s to provide all of the tax and structure benefits of a partnership as well as all of the benefits of an S corporation, including limited liability, single taxation of net income at the equity holder level, and no taxation of income at the entity level.[3]

Once equity holders had a choice of limited liability entities, the question became which pass-through limited liability alternative was preferable, the LLC or the S corporation. This paper demonstrates that the LLC is preferable to the S corporation with respect to ease of formation, ease of avoiding inadvertent termination, flexibility of operation, and maintenance of the entity structure. An S corporation may incur lower accounting costs than an LLC; however, in exchange for higher accounting costs, LLCs receive all of the tax advantages and structuring flexibility of a partnership that are unavailable to an S corporation. An LLC enjoys greater ability to deduct losses than an S corporation, as well as the ability to allocate income and loss among LLC members on whatever economic basis members choose that is denied to S corporations.

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[1] I.R.C. Subchapter C, *especially* §§ 311-316 (2007).

[2] I.R.C. Subchapter S §§ 1361-1379 (2007).

[3] Treas. Reg. §§ 301.7701-1 to 7701-3 (2007).

## II. NON-TAX CONSIDERATIONS AFFECTING CHOICE OF LLC OR S CORPORATION

### A. FORMING AND MAINTAINING AN LLC

There are few restrictions on formation or operation of an LLC. An LLC is established for both non-tax and tax purposes by forming the entity as an LLC under state law.[4] An individual (who need not become a member of the LLC) may form an LLC and choose an Internal Revenue Service (hereinafter referred to as Service) classification allowing it to be taxed as a disregarded entity, partnership, or corporation.[5] If the members are satisfied with the default tax status applied by the Service at formation, no filing is necessary; an LLC may file an election for a different status if the default tax status is unsatisfactory to the LLC.[6] A single-member LLC is taxed as a disregarded entity (i.e., as a sole proprietorship of its equity holder) unless the sole proprietor elects to be taxed as a corporation.[7] A multiple-member LLC is taxed as a partnership unless the members elect to be taxed as a corporation.[8]

If the LLC elects to be taxed as a partnership or as a disregarded entity, all earnings, profits, expenses, and losses are retained by the LLC; while the tax liability for profits and deductions for losses are flowed through to the member(s) at the end of each tax year under partnership tax accounting rules (subject to certain modifications described herein). While members must pay tax on all LLC profits, the profits are treated as increases in each member's capital account unless the LLC elects make a distribution to members. If an LLC elects to be taxed as a C or S corporation, the rules applicable to taxation of a C corporation (including double taxation) or an S corporation (including S corporation pass-through limitations) apply. State LLC statutes require the LLC to maintain entity books and records.[9] The state statutes also limit liability of members to the amount invested in the business plus amounts for which a member is contractually obligated as a lender, guarantor, or surety.[10]

An LLC member holds a membership interest as equity in an LLC in the same sense that a stockholder holds stock as equity in a corporation or a partner holds a partnership interest as equity in a partnership; however, there is no restriction on an LLC having multiple classes of equity representing active and passive interests, senior and junior interests, or any other separate interests the members choose. In addition, there is no restriction on granting only a profits interest to some members.

An LLC may be either a domestic entity organized under the laws of any state or U.S. territory or organized under the laws of a foreign country that meets the U.S. definition of an LLC under the Code.[11] An LLC may be a parent or a subsidiary of another LLC, a corporation, or a partnership. Foreign entities may be corporations or LLCs (if identified as corporations or LLCs in U.S. law); otherwise their status is determined by Treasury Regulation rules.[12]

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[4] *See, e.g.,* N.M. STAT. ANN. § 53-19-1 to-42 (The New Mexico limited liability company statute dealing with the creation and maintenance of an LLC).
[5] N.M. STAT. ANN. § 53-19-7.
[6] Treas. Reg. §§ 301.7701-1-3 (2007).
[7] *Id.*
[8] *Id.*
[9] *See, e.g.,* N.M. STAT. ANN. § 53-19-19.
[10] *Id.*
[11] Treas. Reg. §§ 301.7701-1-3 (2007).
[12] Treas. Reg. § 301.7701-3(a)-(d) (2007); Treas. Reg. § 301.7701-3(b)(2)(i),(ii) (2007); Treas. Reg. § 301.7701-2 (2007) (identifies entities subject to special treatment and those that may not be subject to the elective LLC rules).

The limitations states impose on what businesses can be an LLC vary, but are generally limited; for example, California does not permit law firms or other domestic or foreign professional organizations to be LLCs.[13] The Service imposes almost no ownership, nationality, or structure restrictions on LLCs. The following may not be an LLC: 1) an entity already incorporated as a C or S corporation under federal or state law;[14] 2) an association, including a joint stock association, a company;[15] an Indian tribe,[16] or an insurance company;[17] 3) a state chartered entity insured by FDIC for banking;[18] 4) a business wholly owned by a state or any political subdivision thereof;[19] 5) a business entity taxable as a corporation under a provision other than the Code election provisions;[20] 6) a trust which must be taxed as a trust;[21] and 7) a Real Estate Investment Trust (REIT) that files a REIT election under Code § 856(c).[22] The Service may not terminate the status of an LLC as an LLC for tax purposes unless the entity engages in prohibited activities.

### B. FORMING AND MAINTAINING AN S CORPORATION AND LOSS OF THE S ELECTION

Similar to an LLC, an S corporation is established by creating a corporation under state law;[23] however, unlike an LLC, an S corporation must then make an election with the Service to be an S corporation.[24] State statutes do not distinguish between an S corporation and a C corporation, though some states distinguish between close corporations, which may dispense with some administrative formalities, and general corporations.[25] State statutes require that both a corporation and an LLC maintain books and records.[26] An S corporation may be organized for any lawful purpose except "banking, insurance, credit unions, savings and loan associations, railroads and waterworks organized under the Laws of 1887."[27] Shareholder liability is limited to the amount invested in the business plus amounts for which a shareholder is contractually obligated as a lender;[28] no shareholder need choose to expose him or herself to additional liability.[29]

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[13] CA. CORP. CODE § 17375 (2007), (LLC has no authority to perform certain "professional services"); CA. CORP. CODE § 13401 (defining professional services); Op. of Att. Gen. of California, Lockyer, to California Secretary of State, Shelley, 2003 (attorneys are barred from forming an LLC).
[14] I.R.C. §§ 301 (2007)., Treas. Reg. § 301.7701-2(b)(7) (2007); §§ 1361 et seq. (2007).
[15] Treas. Reg. § 301.7701-3 (2007) (A tax-exempt organization will be classified as an association).
[16] I.R.S. Priv. Ltr. Rul. 9711025 (Dec. 3. 1996). The entity can be liquidated and reformed as an LLC or converted to an LLC; however, there may be significant tax consequences associated with the liquidation or conversion. *Id*.
[17] Treas. Reg. § 301.7701-2(b)(4) (2007).
[18] I.R.C. § 1.581-1(a) (2007); Treas. Reg. § 301.7701-2(b)(5) (2007).
[19] Treas. Reg. §§ 301.7701-(a)(3) and (2)(b)(6) (2007).
[20] *See* Treas. Reg. § 301.7701(a)(3) (including publicly traded partnership under I.R.C. § 7704 and taxable mortgage pools defined in I.R.C. § 7701(i) (2007)).
[21] Treas. Reg. §§ 301.7701-1(b) and 4 (2007).
[22] Treas. Reg. § 301.7701-(3)(c)(1)(v)(B) (2007) (classified as an association).
[23] *E.g.*, N.M. STAT. ANN. § 53-11-1 *et seq.* (Corporations are formed under a state's corporation code.)
[24] I.R.C. § 1362(a) (2007).
[25] REVISED MODEL BUS. CORP. ACT § 7.32. *See also, e.g.*, McMinn v. MBF Operating Acquisition Corp., 142 N.M. 160, 164 P.3d 41 (2007).
[26] N.M. STAT. ANN. § 53-5-2; § 53-11-50.
[27] Treas. Reg. § 1.1361-1(d) (2007); *see also*, N.M. STAT. ANN. § 53-11-3.
[28] I.R.C. §§ 1366, 1367 (2007), Treas. Reg. §§ 1.1367-2(a),(b) (2007), N.M. STAT. ANN. §53-11-25.
[29] *Id*.

An S corporation must be a domestic corporation organized under the laws of any state or U.S. territory or an unincorporated association that meets the Code requirements and makes an election to be taxed as an S corporation.[30] The election of S corporation status must be made by a qualified corporation, with the unanimous consent of the shareholders, on or before the 15th day of the third month of its first tax year in order for the election to be effective beginning that year.[31] An S corporation must be a domestic corporation with one class of equity and with no more than 100 shareholders, all of whom must be U.S. citizens or resident aliens.[32] An S corporation can be a subsidiary of another S corporation.[33]

S corporation status is automatically terminated on the date of any event that would prohibit the corporation from making the election in the first place.[34] If a corporation's S election is inadvertently terminated or invalid when made, and the corporation makes a timely correction, the Service can waive the termination or can permit the election.[35]

Shareholders can inadvertently lose their S corporation election, thus reverting to C corporation classification and subjecting shareholders to double taxation. For example, a corporation's S election is ended in the year following the year a corporation's passive investment income exceeds 25% of gross receipts and the corporation has had accumulated earnings and profits for three consecutive years.[36] Disqualifying passive investment income also results in a 25% tax on passive investment income and termination of S corporation status.[37] Dividends received by an S corporation from an 80% or more owned subsidiary C corporation are not treated as passive investment income from stock ownership if the C corporation's dividends are attributable to the earnings and profits from the active conduct of a trade or business.[38] Investment income from C Corporation banks or financial holding companies is not defined as passive investment income.[39]

Considerable administrative attention is required to avoid inadvertent disqualification. There are limitations both on the number of potential S corporation equity holders and on who may be equity holders. Equity holders in an S corporation are limited to 100.[40] All qualifying members of a family (common ancestors, lineal descendants, and spouses[41] of the ancestor and descendants within six generations) who hold stock are counted as one shareholder.[42] The estate of a family member is treated as a family member.[43] A divorce, distribution of stock from an estate, or a member's transfer of stock to a non-family member, can invalidate the election. An S

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[30] Treas. Reg. § 1.1361-1(c) (2007).
[31] I.R.C. § 1362(a) (2007).
[32] *See* § II(3) *infra.*
[33] I.R.C. § 1361(b)(3)(A) (2007) (the subsidiary is not treated as a separate corporation, and the assets, liabilities, and items of income, deduction and credit are treated as those of the parent S corporation).
[34] I.R.C. § 1362(d)(2) (2007).
[35] I.R.C. § 1362(f) (2007), Treas. Reg. §1.1362-4(a) (2007).
[36] I.R.C. § 1362(d)(3) (2007), Treas. Reg. §1.1362-2(b) (2007).
[37] I.R.C. § 1362(d)(3)(A) (2007) (25% tax on passive investment income and termination of S corporation status).
[38] I.R.C. § 1362(d)(3)(E) (2007).
[39] I.R.C. § 1362(d)(3)(F) (2007).
[40] I.R.C. § 1361(b)(1)(A) (2007).
[41] *Id.*
[42] I.R.C. § 1361(c)(1) (2007). *See also* I.R.C. § 1361(c)(1)(C) (2007) (treating adopted children as blood children).
[43] I.R.C. § 1361(c)(1)(A) (2007).

corporation can avoid the 100 shareholder limit by creating multiple S corporations, each having fewer than 100 shareholders. The S corporations then enter into a partnership with one another and operate as a single entity with allocations to each of the S corporations following the S corporation accounting conventions.[44]

All S corporation equity holders must be U.S. citizens or permanent residents. Ownership by other than a citizen or permanent resident invalidates the S election and subjects the corporation to C corporation double taxation.[45] This creates additional opportunities for termination of the S election. A nonresident alien spouse is not a shareholder of S corporation stock purchased by the other spouse in common law states. However, in a community property state, a non-US citizen spouse is a shareholder of S corporation stock purchased by the other spouse with community property funds, which causes the S corporation election to terminate.[46]

Any domestic trust permitted by IRC § 1361(c) may be an S corporation shareholder; however, no foreign trust may be a shareholder.[47] A grantor of a grantor trust (subpart E trust) is considered to be an eligible shareholder.[48] A grantor trust (subpart E trust) distributes all of its income, loss,[49] basis adjustments,[50] and distributions[51] to its sole beneficiary (note that a married couple is treated as a sole beneficiary), who is treated as the shareholder of the S corporation.[52] Such a trust continues to qualify when the stock is transferred pursuant to a will for a two year period after the death of the beneficiary to allow for distribution.[53] A will creating a trust to which stock is transferred is also a qualifying trust for a two-year period after the death of the settlor.[54] A testamentary trust may hold S corporation stock transferred to it for more than two years if it is a "qualified subpart E trust,"[55] "qualified subchapter S trust,"[56] or electing small business trust.[57] A qualified terminable interest property trust that meets estate tax requirements[58] is a permitted S corporation shareholder if it otherwise qualifies as a qualified subchapter S trust.[59]

Qualified beneficiaries of a qualified trust include a tax exempt Code § 501(c)(3) organization, or an electing small business trust having as beneficiaries only individuals, estates, and certain tax exempt organizations.[60] An estate in bankruptcy

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[44] Rev. Rul. 94-43, 1994-2 C.B. 198.

[45] I.R.C. § 1361(b)(C) (2007).

[46] Treas. Reg. § 1.1361-1(g) (2007); I.R.C. § 1361(e)(1) (2007); Treas. Reg. § 1.1361-1(g) (2007).

[47] I.R.C. § 1361(c)(2)(A) (2007) (identifying permitted trusts and prohibiting foreign trusts).

[48] I.R.C. § 1361(c(2)(A); Treas. Reg. § 1.1361-1(h) (2007).

[49] I.R.C. § 1366 (2007).

[50] *Id.* § 1367 (2007).

[51] *Id.* § 1368. Separate and independent shares of the same trust are treated as separate trusts for this purpose. I.R.C. §§ 1361(c)(2) (2007), 1361(d) (2007), Treas. Reg. § 1.1361-1(h) (2007); Treas. Reg. § 1.1361-1(j) (2007).

[52] I.R.C. § 678(b)(2007).

[53] *Id.* § 1361(e)(2)(A)(ii).

[54] I.R.C. § 1361(e)(2)(A)(iii).

[55] *Id.* § 1361(c)(2)(A)(i). A qualified Subpart E trust is any trust included in Code Subchapter J, "Estates, Trusts, Beneficiaries, and Decedents;" Subpart E, "Grantors and Others Treated as Substantial Owners [of Trusts];" I.R.C. §§672-679.

[56] I.R.C. § 1361(c)(2) (permitting a qualified subchapter S trust).

[57] I.R.C. §1361(c)(2)(A)(ii) (2007), Treas. Reg. § 1.1361-1(h)(3) (2007).

[58] I.R.C. § 2056(b)(7) (2007).

[59] I.R.C. § 1361(e)(2). It must qualify as a qualified subchapter S trust by being wholly owned by the grantor pursuant to I.R.C. § 2523(f) (2007).

[60] I.R.C. § 1361(e)(1)(A) (2007). In addition, the interest cannot have been acquired by purchase, and an election must be made under I.R.C. § 1361 to treat the trust as an "Electing Small Business Trust," I.R.C. § 1361(e)(1)(A)(ii), (iii) (2007).

may be an S corporation shareholder and a bankrupt estate may elect S corporation status.[61] A voting trust is an eligible shareholder if it: 1) is created under a written trust agreement; 2) delegates the voting right to one or more trustees; 3) treats the beneficial owners of the trust as the owners of the stock in proportion to their respective trust portions; 4) distributes all benefits to or on behalf of the beneficial owners of the stock; and 5) delivers title to the stock to the beneficiaries at termination of the trust under state law, by its terms, or on or before a specific date or event.[62]

An electing small business trust (ESBT) can be an S corporation shareholder so long as it does not have any beneficiaries other than individuals, estates, and charitable organizations; has no interests acquired by purchase; has not made a qualified subchapter S trust election with respect to any stock held by the trust; and is not a tax-exempt trust, a charitable remainder annuity trust, or a unitrust.[63] Each potential current beneficiary of the trust is treated as a shareholder, unless there is no potential current beneficiary of the trust for any period, in which case the trust itself is treated as the shareholder.[64] Any person who may receive a distribution at the discretion of any person is a potential current beneficiary for purposes of counting number of shareholders. One who may benefit from a power of appointment is not a potential current beneficiary if the power has not been exercised.[65] While nonresident aliens may not be potential current beneficiaries, they may otherwise be beneficiaries of an ESBT.[66] A potential current beneficiary who would otherwise disqualify an S corporation has one year to dispose of the stock.[67]

A beneficiary of a charitable remainder trust cannot be an eligible S corporation,[68] nor can a beneficiary of a trust qualifying as an IRA.[69] A Code § 501(c)(3) charitable organization[70] or Section 401(a) qualified retirement plan trust (profit sharing or stock bonus plan) may be a shareholder in an S corporation[71] and will be counted as one shareholder.[72]

A qualified subchapter S trust (QSST) is a trust that: 1) owns stock in at least one S corporation; 2) distributes all of its income only to a citizen or resident alien of the U.S.; 3) has only one current income beneficiary; 4) distributes any corpus during the life of the current income beneficiary only to the income beneficiary; 5) terminates the income interest of the current income beneficiary at the earlier of the termination of the trust or the beneficiary's death; and 6) treats the sole beneficiary as owner of S corporation stock held by the trust.[73] The beneficiary may also hold stock in the S corporation.[74] A QSST must distribute all of its income and corpus to the sole beneficiary, who must be a citizen or resident alien of the U.S.[75] Successive income beneficiaries are permitted.[76]

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[61] Treas. Reg. § 1.1361-1(b)(2) (2007).
[62] *Id.* § 1.1361-1(h)(1)(v) (2007).
[63] I.R.C. § 1361(e) (2007).
[64] I.R.C. § 1361(c)(6) (2007).
[65] I.R.C. § 1361(e)(2).
[66] Treas. Reg. § 1.1361-1(m)(1)(ii)(D) (2007).
[67] I.R.C. § 1361(e)(2) (2007).
[68] Rev. Rul. 92-48, 1992-2 C.B. 377.
[69] I.R.C. § 581 (2007) (providing an exception for IRAs that held S corporation shares prior to October 22, 2004).
[70] I.R.C. § 501 (2007).
[71] *Id.* §§ 1361(b)(1)(B), 1361(c)(6) (2007).
[72] P.L. 104-188 S. Rept. No. 104-281, p. 61.
[73] I.R.C. § 1361(d)(3)(A)(2007)
[74] *Id.* Note that substantially separate and independent shares of a QSST are treated as a separate trust, I.R.C. § 1361(d)(3)(B) (2007).
[75] *Id.* §§ 1361(d)(3)(A)(i),(ii) (2007), 1361(d)(3)(B)(2007).

Each income interest must end no later than the death of the income beneficiary. If the trust ends at any time during the life of the income beneficiary, it must distribute all of its assets to the beneficiary. The QSST beneficiary is taxed on all items of income, loss, deduction, and credit attributable to the S corporation stock held by the QSST even though the QSST is the owner of the stock.[77] The tax consequences of the disposition of the trust's S corporation stock are determined by the provisions of Code § 1361.

Stock ownership of an S corporation through an LLC does not terminate a corporation's S election,[78] if the LLC elects to be taxed as a partnership or as a disregarded entity (sole proprietorship).[79] Each member is treated as the direct owner of the S corporation stock.

S corporations present a minefield of potential disqualifications from pass-through status for the uninformed or inattentive. In contrast to the many restrictions imposed on ownership of an S corporation, LLC members have no limit on number or nationality of equity holders and therefore no risk of loss of single taxation pass-through status comparable to that faced by S corporation shareholders. Both U.S. citizens and non-resident aliens may be LLC members.[80] Corporations, trusts, and partnerships can be members of an LLC. There are no restrictions on LLCs comparable to those imposed on S corporations.

### C. Jurisdiction Rules for S Corporations and for LLCs

Both an S corporation and an LLC must be represented by an attorney; neither can be represented by a non-lawyer member, shareholder, or manager in court proceedings.[81] Courts exercise jurisdiction over both S corporations and LLCs when they are formed in the state, register to do business in the state, or act in the state without registering to do business. Similarly, a court possesses personal jurisdiction over both an S corporation and an LLC if the entity was formed in the state, has registered to do business in the station, or is present in the state, even though not registered. In addition, states have long-arm statutes designed to establish personal jurisdiction over an entity's commercial contacts with the state when it is operating from another jurisdiction. Some states are extremely aggressive with respect to

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[76] *Id.*

[77] Treas. Reg. § 1.1361-1(j)(7) (2007).

[78] Letter Ruling 200107025.

[79] Treas. Reg. § 301.7701-3 (2007).

[80] I.R.C. § 1446(b) (2007) (a non-resident alien may be exposed to U.S. taxes by being taxed as a member of an LLC).

[81] *See* Martinez v. Roscoe, 33 P.3d 887 (N.M. App. 2001), *cert. denied*, 130 N.M. 558, 28 P.3d 1099(2001) (New Mexico specifically prohibits representation of an LLC by a non-attorney). Disciplinary Counsel v. Kafele, 843 N.E.2d 169 (Ohio 2006) (such activities performed by a non-lawyer constitutes the unauthorized practice of law); Board of Education v. Franklin County Board of Revision, Nos. 01AP-878, 01AP-879, 202 WL 416953 (Ohio App. March 19, 2002); Cleveland Bar Ass'n v. Pearlman, 832 N.E.2d 1193 (Ohio 2005); (exceptions are limited and of little practical importance); Valiant Ins. Co. v. Nurse Network, LLC, No. CV 980578083, 1998 WL 712359 (Conn. Super. Ct. 1998) (an early and rare exception to a long line of Connecticut cases holding representation by attorneys is required, states in dicta that if both members of two member LLC make pro se appearances no attorney need represent them). *See also* Winzer v. EHCA Dunwoody, 628 S.E. 2d 426 (Ga. App. 2006) (affirming dismissal of appeal because LLC was required to be represented by attorney and failed to obtain proper legal representation for more than 2½ years). *See also,* Energy Lighting Mgmt., v. Kinder, 363 F.Supp.2d 1331 (M.D. Fla. 2005); Gilley v. Shoffner, 345 F.Supp.2d 563 (M.D. N.C. 2004); Board of Educ. v. Franklin County Bd. of Revision, Nos. 01AP-878, 01AP-879, 2002 WL 416953 (Ohio, App. March 19, 2002) (LLC must be represented by an attorney in a tax valuation dispute); In re ICLNDS Notes Acquisition, 259 B.R. 289 (Bankr. N.D. Ohio 2001). *Accord,* In re 1103 Norwalk Street, L.L.C., No. 01-10059C-7G, 2004 WL 3502654 (Bankr. M.D. N.C. May 14, 2004) (an LLC must be represented by counsel to file a bankruptcy petition).

establishing personal jurisdiction over an LLC or an S corporation not registered to do business in the state.[82] A plaintiff must allege an occurrence that falls within the long-arm statute, and the court must find the requisite minimum contacts to comport with the due process requirements for establishing jurisdiction.[83]

States such as New Mexico reject the fiduciary shield doctrine and hold that any entity or person who either does business in the state or commits a tortuous act in the state is subject to personal jurisdiction.[84] Generally, states do not claim jurisdiction over a nonresident LLC and its indirect owner when the only contact with the state was filling an order placed over the Internet from an out of state warehouse.[85] A court generally only has personal jurisdiction over an S corporation or an LLC as a separate entity with respect to disputes between the entity and those parties. It generally does not have personal jurisdiction over S corporation shareholders or managers or over LLC members or managers in their individual capacities for violations committed by the entity.[86] However, those involved in active management of an LLC are more likely to be subject to a state's jurisdiction than are passive members.[87] If the ownership interest of an LLC member or an S corporation shareholder includes some amount of control and direction, the state is likely to exercise personal jurisdiction over the executive.[88] For example, an executive who travels to a state to conduct business and communicates with the majority member in that state is likely to be subject to that state's jurisdiction.[89] However, in New York, a defendant's acquisition of a 99% interest in a New York LLC is sufficient to give New York courts personal jurisdiction over the buyer even when the buyer never entered New York.[90] Operating through a subsidiary LLC will usually insulate member owners of the parent LLC from being subject to personal jurisdiction

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[82] *See* Melfi v. Goodman, 368 P.2d 582 (N.M. 1962).

[82] United Nuclear Corp. v. Gen. Atomic Co., 91 N.M. 41, 42, 570 P.2d 305, 306 (1977) (New Mexico's long-arm statute will extend as far as the constitution allows).

[83] Santa Fe Tech's v. Argus Networks, Inc., 42 P.3d 1221, 1229 (N.M. App. 2001).

[84] *Id*.

[85] Origins Natural Resources, Inc. v. Kotler, 133 F. Supp. 2d 1232 (D. N.M. 2001).

[86] Jordan v. Commonwealth, 549 S.E.2d 621 (Va. App. 2001).

[87] Fisher v. Blackmore, 325 F.Supp.2d 810 (E.D. Mich. 2004) (A Michigan court found a member of a Michigan LLC who was a Massachusetts citizen to be subject to personal jurisdiction on grounds the member entered the state to conduct LLC business related to operations in Michigan); Lawson v. Tax Lien Res. Group, No. 98 C 245, 1998 WL 957331 (N.D. Ill. Dec 15, 1998) (An Illinois resident who is a member of a Delaware LLC with its principal place of business in Michigan can establish jurisdiction over Michigan members of the LLC based on minimum contacts consisting of the Michigan members' travel to Illinois to discuss LLC business with the plaintiff). *See also* Fisher v. Blackmore, 325 F.Supp.2d 810 (E.D. Mich. 2004) (Massachusetts resident member of Michigan LLC who entered state to conduct LLC business and received benefits from the LLC); XL Vision, LLC v. Holloway, 856 So.2d 1063 (Fla. App. 2003) (LLC's foreign parent and LLC's president subject to personal jurisdiction in Florida where the complaint alleged both had formed and operated the LLC in a manner that defrauded creditors and where the subsidiary and parent commingled funds and did not maintain LLC formalities). *Compare* LaSalle Bank N.A. v. Mobile Hotel Properties, LLC, 274 F.Supp.2d 1293 (S.D. Ala. 2003) (plaintiff did not allege facts sufficient for court to find parent LLC was the alter ego of its subsidiary LLC for purposes of establishing jurisdiction over the parent as the party responsible for the subsidiary LLC's actions).

[88] Fields v. Excel Inv., No.1:05CV00093 JLH, 2006 WL 335359 (E.D. Ark. Feb. 13, 2006). Proof of one transaction is sufficient to confer jurisdiction under New York Law as long as the act was purposeful and it had a substantial relation to the asserted claim, Atwal v. Atwal, 807 N.Y.S.2d 776 (N.Y. A.D. 4 Dept. 2005). The New York result is quite different from a Texas ruling that forming LLCs and making occasional visits to Texas were insufficient to establish personal jurisdiction where the LLCs had never maintained their principal place of business in Texas. Paolino v. Argyll Equities, L.L.C., 401 F.Supp.2d 712 (W.D.Tex. 2005).

[89] Clockwork Home Services, Inc. v. Robinson, 423 F. Supp.2d 984 (E.D. Mo. 2006).

[90] *See* Atwal, 807 N.Y.S.2d at 776.

in the state in which the subsidiary operates,[91] unless they are charged with unlawful acts committed by managing members of a foreign LLC against residents of the state seeking jurisdiction.[92]

Diversity jurisdiction is determined by statute for corporations and by common law for partnerships. A corporation is subject to jurisdiction at its principal place of business and at its state of incorporation pursuant to federal law on diversity jurisdiction.[93] Federal law does not mention either partnerships or LLCs, so courts developed separate rules on jurisdiction pursuant to Carden v. Arkoma Associates,[94] in which the Supreme Court held that a partnership is a citizen of every state in which a general or limited partner resides. The courts have held that LLCs are analogous to partnerships in this respect and are subject to jurisdiction in any state where a member resides.[95] Thus, disputes involving LLCs are more likely to be subject to state jurisdiction; whereas those involving S corporations are more likely to be subject to diversity jurisdiction.

### D. ACCOUNTING COSTS OF S CORPORATIONS AND LLCS

The required structure of an S corporation's accounts is similar to that of a C corporation. Items of income and expense must be passed through to shareholders proportionally with each shareholder's stock ownership interest for tax purposes, but may be held in the S corporation as additional capital.

An LLC that elects to be taxed as a C or S corporation has the same accounting structure as an S corporation. An LLC taxed as a disregarded entity has the same accounting structure as a sole proprietorship. To the extent that an LLC elects partnership accounting, the LLC accounting structure can be more complex than an S corporation's accounting structure. If income and expense distributions to members are proportionate with member capital contributions, and if the LLC does not make elections to alter the value of inside basis or receive contributions or make distributions of appreciated property, the LLC incurs accounting costs similar to those of an S corporation.

An LLC may take advantage of the following tax advantages not available to S corporations: 1) tax free contributions and distributions of appreciated property; 2) distributions of income and expense that are not proportional with members' ownership interests; 3) special elections; and 4) multiple classes of equity and complex debt structures. As a result, LLCs taking advantage of such provisions often incur higher accounting costs than do S corporations. The higher accounting costs are the price of substantial tax benefits an LLC can provide its equity holders relative to those

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[91] Greystone Tribeca Acquisition v. Ronstrom, 863 So.2d 473 (Fla. App. 2004).

[92] *See* XL Vision, LLC, 856 So.2d at 1063 (LLC's foreign parent and LLC's president subject to personal jurisdiction in Florida where the complaint alleged both had formed and operated the LLC in a manner that defrauded creditors and where the subsidiary and parent commingled funds and did not maintain LLC formalities). *Compare* LaSalle Bank, 274 F.Supp.2d at 1293 (plaintiff did not allege facts sufficient for court to find parent LLC was the alter ego of its subsidiary LLC for purposes of establishing jurisdiction over the parent as the party responsible for the subsidiary LLC's actions).

[93] 28 U.S.C. § 1332(c) (2007).

[94] 494 U.S. 185 189, 195-96 (1990).

[95] *See, e.g.*, Hicklin Eng'g. v. Bartell, 439 F.3d 346 (7th Cir. 2006); Johnson v. Columbia Prop. Anchorage, 37 F.3d 894 (9th Cir. 2006); Rolling Greens MHP v. Comcast SCH Holdings, 374 F.3d 1020 (11th Cir. 2004); Mut. Assignment & Indem. v. Lind-Waldock & Co., 364 F.3d 858 (7th Cir. 2004); Handelsman v. Bedford Vill. Assoc., 213 F.3d 48 (2d Cir. 2000).

available to S corporation equity holders. There are few situations where an S corporation may produce better tax results than an LLC.

## III. TAX CONSIDERATIONS ASSOCIATED WITH FORMING AN LLC OR S CORPORATION

There are many Code provisions that affect the level of tax incurred by S corporation stockholders and by LLC members. The Code generally offers more favorable tax treatment to LLC equity holders than it does to S corporation equity holders.

### A. EQUITY FINANCING

S corporations are prohibited from issuing more than one type of equity, which reduces S corporation shareholder flexibility, can increase shareholder tax liability, and can create difficulties securing financing.[96] An S corporation can issue both voting and non-voting stock (e.g., to employees who receive non-voting stock, or voting stock with restrictions on voting) as a profits interest without violating the single class of stock rule.[97]

Like a C corporation, an LLC may issue membership interests comparable to different classes of preferred stock, common stock, convertible debt, and other financial instruments without losing its pass-through status. An LLC may have separate membership interests analogous to the interests of general partners in a partnership and membership interests analogous to the interests of limited partners. Rights of different equity holders with respect to allocations of income, expense, and liquidation of assets may differ; allocations need not be proportional with the share of equity owned. LLCs electing to be taxed as partnerships are subject to partnership tax rules that permit such flexibility.[98]

### B. DEBT FINANCING

S corporations may only issue straight debt financing with stated interest and repayment schedules without jeopardizing S corporation status.[99] Straight debt is any written unconditional promise to pay a creditor, on demand or on a specified date, a sum certain in money, provided that the interest rate and payment dates are not contingent on the borrower's profits or discretion, and the debt cannot be converted into stock.[100] For both S corporations and LLCs, if the debt instrument does not fall within the Service's defined safe harbor the Service can recharacterize financing labeled as debt as an additional class of equity. This means that any debt with indefinite repayment schedules, participation in profits or losses, or other "hybrid features" could result in the Service classifying the debt as a second class of equity. For an S

[96] I.R.C. § 1361(b)(c) (2007); Treas. Reg. § 1.1361-1 (2007). S corporations can issue both voting and non-voting shares. § I.R.C. § 1361(c)(4) (2007).

[97] Rev. Proc. 92-27, 1993-2CB 343.

[98] The rules permitting LLCs to elect partnership taxation are found at Treas. Reg. §§ 301.7701-1 to .7701-3 (2007). The applicable partnership tax rules are found in Subchapter K of the Code, especially §§ 701-705, 707, 721-724, 731-737, 741-743, and 751-755.

[99] I.R.C. § 1361(c)(1)(A)(5) (2007); anything classified as "straight debt" is not a second class of equity, Treas. Reg. § 1.1361-1(b)(5) (2007).

[100] I.R.C. § 1361(c)(5) (2007).

corporation, this creates a second class of stock, causes the corporation to lose its S corporation status, triggers double taxation, and converts payments deductible as an interest expense into equity payments, which are treated as income to the S corporation's shareholders.[101]

An LLC may issue multiple types of straight and hybrid debt without risking loss of pass-through single taxation treatment. The instruments are treated as an additional class of stock if the Service reclassifies the instrument as equity[102] or if they resemble a call, a warrant, or some other vehicle that can be converted into a participatory interest.[103] Reclassifying LLC debt as equity converts deductible interest expense into income, and debt holders into equity holders. The income is taxable to the equity holders and must be reallocated among the expanded number of equity holders in accordance with the recharacterization.[104] It does not result in loss of LLC status or in double taxation. A similar finding by the Service with respect to S corporation debt results in loss of the S corporation election and taxation of the resulting income at both the corporate and the individual shareholder level.

### C. Equity Contribution to a New or Existing S Corporation

Equity investors recognize no gain or loss on contributions made to form an S corporation or to acquire an existing corporation from existing shareholders only under the following conditions: 1) the transfer consists of property (including cash); 2) the transfer is solely in exchange for stock; and 3) the transferors are in control (own more than 80% of the corporation) immediately after the exchange.[105] The following are not treated as property: 1) services provided by a shareholder; 2) transferee debt not evidenced by a security; and 3) interest on a transferee's debt accrued after the beginning of the transferor's holding period.[106] A transferee corporation's assumption of a liability is not treated as a cash payment to the sellers unless the sum of all liabilities assumed exceeds the adjusted basis of all properties transferred to the transferee by the transferor.[107] If transferors of assets want to recognize loss or gain, they can form a corporation with cash and then sell the assets to the corporation to create a recognition event.[108] Transferors may recognize gain or loss on sale of assets to the corporation unless the shareholder and corporation are related parties (i.e., parties owning 50% or more of the value of the corporation's outstanding stock).[109]

Except under the above circumstances, contribution of appreciated property to an S corporation is generally a taxable event. After formation, the contribution of appreciated assets to a corporation in exchange for stock requires the transferor to recognize gain or loss equal to the difference between adjusted basis of the contributed asset in the transferor's hands and the fair market value of the stock received in exchange.[110]

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[101] I.R.C. § 1361(c)(5)(B) (2007); Treas. Reg. § 1.1361- 1(l)(4)(iii)(B)(1) (2007) (ineligible person exercising conversion feature may cause S corporation election to be lost).

[102] Treas. Reg. § 1.1361(4)(l)(4)(ii) (2007).

[103] *Id*. § 1.1361(4)(l)(4)(iii) (2007).

[104] *See, e.g.*, Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 630 (6th Cir. 1986), *aff'g*, T.C.M. 1985-58 (11 factors to be examined to distinguish debt from equity).

[105] I.R.C § 351 (2007).

[106] I.R.C § 351(d) (2007).

[107] I.R.C § 357(a) (2007).

[108] This removes the transaction from I.R.C. § 351.

[109] I.R.C. §§ 267, 1239 (2007).

[110] Such a transaction does not qualify under I.R.C. § 351 and is therefore not a tax free transaction.

### D. Equity Contribution to a New or Existing LLC

Contribution of appreciated property to an existing LLC is generally a non-recognition event. No gain or loss is recognized on contributions of cash or of appreciated assets.[111] The result is the same whether the contribution is made to form a new LLC or to acquire an equity interest in an existing LLC.[112] Instead of contributing property to the LLC, the transferor may agree to sell the property to the LLC, recognize gain or loss, and then contribute the proceeds in exchange for the equity interest.[113]

After formation, contribution of appreciated assets to an LLC in exchange for a membership interest is also a non-taxable event, regardless of whether the contribution is made by a new or existing member.[114] Contributions of property whose fair market value is above the contributor's basis do create a taxable event if the transfer is found to be a disguised sale.[115] For cash basis taxpayers, gain or loss on unrealized receivables contributed to an LLC is treated as ordinary income or loss to the contributor, not to the LLC, when the receivables are collected.[116] Gain or loss on substantially appreciated inventory in the hands of the contributing member is treated as ordinary income or loss to the LLC on disposition of the inventory.[117] Gain or loss on capital assets a member contributes to an LLC that the LLC disposes of within five years of contribution is treated as gain or loss to the contributing member to the extent of the contributing member's unrecognized gain at the time of contribution. Any remaining gain is treated as gain or loss to the LLC. The LLC's gain is capital gain or loss or ordinary gain or loss depending on how the asset is used by the LLC. [118] While gain on capital assets contributed to the LLC is not taxed at contribution, any recapture of depreciation is allocated upon disposition to the contributing member to the extent of the difference between disposition price and member's basis on contribution.[119]

### E. Transfers of Services or of Assets Subject to Debt for an Equity Interest

Transfer of either an LLC membership interest or S corporation shares in exchange for current services is treated as purchase of services by the entity from the contributing member. The fair market value of the resulting equity interest is taxed to the member as ordinary income, and the equity interest is deemed to have been purchased by that income.[120] When a member receives an equity interest in exchange for providing

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[111] I.R.C. § 721 (2007).
[112] Treas. Reg. § 1.721-1(a) (2007)
[113] *Id.*
[114] *Id.*
[115] The disguised sale rules do not prevent tax free contribution but impose tax on subsequent transfers to
other parties; *see* I.R.C. §§ 707(a)(2)(B) (two-year rule for directly reciprocal contributions and distributions), 737 (seven-year rule for directly reciprocal contributions and distributions), and 704(c)(1)(B) (2007) (seven-year rule for indirectly reciprocal contributions and distributions).
[116] The ordinary income must be allocated to the contributor to the extent the gain occurred before transfer,
I.R.C. § 724 (2007); unrealized receivables are defined at I.R.C. § 751(c) (2007).
[117] *Id.* § 724(b) (2007); the definition of inventory items is found at I.R.C. §§ 724(d)(2), 751(d)(2) (2007).
[118] *Id.* § 724(c) (2007).
[119] *Id.* § 704(c) (2007); *see also* treatment of recapture under I.R.C. §§ 1245 and 1250 property, Treas. Reg. §§ 1.1245-2(c)(2) (2007), and 1.1250(3)(c)(3) (2007).
[120] I.R.C. § 83(a) (2007).

current services, transfer of future LLC or S corporation income is taxed as income only when received.[121]

Taking assets subject to a debt that is in excess of the contributor's basis in the assets is a taxable event 1) to the extent of the difference if the assets are contributed to an S corporation, and 2) to the extent that the contributing member is relieved of liability for any portion of the loan in excess of the contributing member's basis in the property.[122]

### F. Capacity of LLCs and of S Corporations to Deduct Losses

Both an S corporation shareholder and an LLC member may deduct an equity holder's share of pass-through items of expense, deduction, and loss to the extent of adjusted basis in the entity. Adjusted basis consists of capital contributions plus income earned during the year, less losses, deductions, and distributions for the year, plus debt owed to the shareholder by the corporation.[123] LLCs have an advantage over S corporations with respect to an LLC's ability to increase member basis in the entity (and therefore increase members' capacity to deduct losses).

An S corporation shareholder receives no increase in basis as a result of guaranteeing debts of the corporation.[124] An S corporation shareholder can only increase basis by 1) increasing equity investment, 2) lending money directly to the S corporation, or 3) employing qualified non-recourse financing.[125] Only when a shareholder lends money to the S corporation is S corporation debt to the shareholder included in the shareholder basis.

Qualified non-recourse financing is debt financing provided by a qualified person to an S corporation or LLC if such financing is provided with respect to qualified business property.[126] To qualify: 1) the property must be used by the corporation in the active conduct of a trade or business; 2) the corporation must have at least three full time employees who are not owner employees (i.e., own less than 5% in value of the outstanding stock of the corporation);[127] 3) substantially all of the services provided

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121 Rev. Proc. 93-27, 1993-2 C.B. 343.

122 In such a case the difference is treated as capital gain to the contributing member at the time of contribution, I.R.C. § 731(a). Treatment of the contribution with respect to the other members is explained by Treas. Reg. §§ 1.722-1 and 1.752-1 (2007). *See also* I.R.C. §§ 351(b), 357(c)(1) (2007) (the provisions address contributions when afterwards the shareholder is in control). I.R.C. § 731(a)(1) (2007) (applies to LLCs when any contribution is made for an equity interest).

122 I.R.C. § 1366(d)(1) (2007), Treas. Reg. § 1.1366-2 (2007).

123 I.R.C. § 705 (2007); Treas. Reg. § 1.705-1 (2007).

124 I.R.C. § 1366(d)(1) (2007), Treas. Reg. § 1.1366-2 (2007), (shareholder receives no basis increase for guarantee of debts of the corporation). *See also* Spencer v. Comm'r., 110 T.C. 62 (1998), *aff'd,* 194 F.3d 1324 (11th Cir. 1999); Estate of Leavitt v. Comm'r, 90 T.C. 206 (1988), *aff'd*, 875 F.2d 420 (4th Cir. 1989), *cert. denied*, 493 U.S. 958 (1989); Harris v. United States, 902 F.2d 439 (5th Cir. 1990); Brown v. Comm'r, T.C. 1981-608 (1981), *aff'd*, 706 F.2d 755 (6th Cir. 1983); Grojean v. Comm'r, T.C.M. 1999-425 (1999), *aff'd,* 248 F.3d 572 (7th Cir. 2001); Goatcher v. United States, 944 F.2d 747 (1991, CA10); Sleiman. v. Comm'r, 187 F.3d 1352 (11th Cir. 1999). However, Selfe v. United States, 778 F.2d 769 (11th Cir. 1985) provides for a limited exception. Even then, the exception does not apply if the lender looks first to the corporation rather than to the shareholders for repayment. Salem v. Comm'r, T.C.M. 1998-63 (1998), *aff'd,* 196 F.3d 1260 (11th Cir.1999).

125 *See* I.R.C. § 1366(d)(1) (2007), and I.R.C. §§ 351, 357 (2007).

126 I.R.C. § 49(a)(1)(E) (2007); *Id*. § 465(b)(6) (2007).

127 *Id*. § 465(c)(7)(E)(i) (2007).

must be directly related to such trade or business; and 4) the entity must have at least one full-time employee who was in the active management of the trade or business.[128]

An LLC member may increase basis in ways an S corporation shareholder cannot. Unlike a partner in a partnership,[129] when a member acquires an interest in an LLC, the member does not assume liability for LLC recourse debt unless the member affirmatively agrees by contract to become liable for some or all of the debt.[130] An LLC member includes debt in basis for purposes of deducting losses to the extent that the LLC member is at risk for repayment of the debt in the event that the LLC becomes unable to repay, or the debt is qualified non-recourse financing.[131]

Like S corporation members, an LLC member may increase basis in the LLC by lending money to the LLC or by agreeing to become personally liable for repayment of LLC debt as a guarantor.[132] Pledging property as security for an LLC liability creates basis.[133] The pledge can be a direct pledge in which the LLC member is "considered to bear the economic risk of loss" for an LLC liability to the extent of the value of any of the member's (or related person's) separate property [134] or an indirect pledge in which the LLC member is "considered to bear the economic risk of loss" for an LLC liability to the extent of the value of any property that the member contributes to the LLC solely for the purpose of securing an LLC liability.[135]

Guaranteeing interest on a liability that is otherwise non-recourse to the member also creates basis against which LLC losses may be deducted on the following terms: 1) the guarantee must include a commitment by a member that guarantees the payment of more than 25% of the total interest that will accrue on a LLC liability over its remaining term; and 2) it must be reasonable to expect the guarantor will be required to pay substantially all of the guaranteed future interest if the LLC fails to do so. The member is treated as bearing the economic risk of loss for the LLC liability to the extent of the present value of the guaranteed future interest payments, computed either using the stated rate in the loan documents or, if interest is imputed,[136] the applicable federal rate compounded semiannually.[137] Irrespective of the form of a contractual obligation:

> A [member] is considered to bear the economic risk of loss . . . to the extent that: (i) The partner . . . undertakes . . . contractual obligations

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[128] *Id*. § 49(a)(1)(E)(iii) (2007).

[129] *Id*. § 752(a) (2007).

[130] *E.g.*, N.M. STAT. ANN. § 53-19-13 (providing for this limitation on liability).

[131] I.R.C. § 752 (2007); Treas. Reg. § 1.752-1(a)(2007).

[132] *See, e.g.*, Gefen v. Commissioner, 87 TC 1471 (1986); Abramson v. Commissioner, 86 T.C. 360 (1986) (limited partner who personally guarantees limited partnership's non-recourse debts was at risk for the portion of the debt guaranteed); Melvin v. Commissioner, 88 T.C. 63 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990) (that debts do not become payable in a particular year does not preclude the debts from being included in the at-risk amounts from which losses may be deducted).

[133] Treas. Reg. § 1.752-2(h) (2007).

[134] *Id*. § 1.752-2(e) (2007); *Id*. § 1.752-2(h) (2007). The guarantee can also be provided by a *related person* as defined in Treas. Reg. § 1.752-2(b)(1)(B) (2007). The Regulations reference the related party rules of I.R.C. §§ 707(b)(1) and 267(b) (2007), but substituting 80% for the 50% rule contained in those provisions.

[135] Treas. Reg. § 1.752-2(h)(2) (2007). Note: All of the items of income, gain, loss, and deduction attributable to the contributed property must be allocated to the contributing member. *Id*.

[136] As permitted by I.R.C. §§ 483 or 1274.

[137] Treas. Reg. § 1.752-2(a) (2007).

> so that the [LLC] may obtain a loan; (ii) The contractual obligation . . . eliminate[s] substantially all the risk to the lender that the [LLC] will not satisfy its obligations under the loan; and (iii) One of the principal purposes . . . is to attempt to permit [LLC members] to include a portion of the loan in the basis of their [LLC] interests.[138]

### G. Basis Created by an LLC Deficit Restoration Obligation

A deficit restoration obligation (hereinafter referred to as DRO) will make the liability recourse to the member.[139] Even without formal assumption of debt, an LLC member can become personally liable for debts by including provisions in the LLC's operating agreement that make the member liable for debt that is otherwise recourse to the LLC, but non-recourse to the member under state law. The test is whether the member is obligated as the obligor of last resort to pay the debt in the event that, in a worst case scenario, the LLC is unable to repay the debt.[140] A DRO is an agreement entered into by an LLC member with the LLC under which, if the member's basis falls below zero, the member agrees that either additional items of income will be allocated to the member or, in the absence of such allocation, the member will make contributions of capital to restore a positive capital balance.[141] An enforceable DRO creates recourse debt to the LLC member to the extent of the negative basis amount the member is required by contract to contribute to the LLC if the LLC cannot otherwise pay its debts. To the extent a DRO is reachable by creditors in an actual liquidation the concerns raised by some about whether a DRO permits an LLC member to deduct losses in excess of basis are groundless.[142]

The Treasury Regulations provide an example of how a DRO is applied.[143] C and D each contribute $500 in cash to the capital to the new LLC. The LLC uses the funds to purchase property from an unrelated seller for $1,000 in cash and a $9,000 mortgage note as a general obligation of the LLC. The operating agreement provides that profits and losses are to be divided 40% to C and 60% to D. C and D each have a DRO and are required to make up any deficit in their capital accounts. In a constructive liquidation, all LLC assets are treated as if they become worthless, all LLC liabilities become due and payable in full, and the LLC is treated as if it disposed of all assets in a fully taxable transaction for no consideration. Capital accounts are adjusted to reflect the loss such that C bears 40% of the losses or $4,000 and D bears 60% of the losses or $6,000. The example continues, C would have to make an additional capital contribution of $3,500 under the DRO and D would have to make an additional capital contribution of $5,500 under the DRO. The Regulations conclude, "[T]he $9,000 mortgage note is a recourse liability because one or more members bear the economic risk of loss for the liability. C's share of the recourse liability is $3,500 and D's share is $5,500."[144]

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[138] *Id*. § 1.752-2(j)(2) (2007).

[139] Some have argued that a DRO will not suffice to make the liability recourse to the member; *see* S. Starr, et al., "Limited Liability Companies," 725-2nd Tax Mgmt. (BNA) A-45–A-46, 75-78 (2003) (hereinafter referred to as *Starr, et al.)*; Hubert Enters, Inc. v. Comm'r, T.C.M. 2008-46, *aff'g* 125 T.C. 72 (2005), *aff'd in part, vac'd in part and rem'd*, 230 Fed. Appx. 526 (6th Cir. 2007).

[140] Martuccio v. Comm'r, 30 F.3d 743, 750-51 (6th Cir. 1991); Emershaw v. Comm'r, 949 F.2d 841, 848-51 (6th Cir. 1991); Thornck v. Comm'r, 94 T.C.M. 439 (CCH) (1990); Krause v. Comm'r, 92 T.C.M. 1003 (CCH) (1989); Melvin v. Comm'r, 894 F.2d 1072 (9th Cir. 1990).

[141] *See* I.R.C. § 704 (2007); Treas. Reg. § 1.704-1(b)(3) (2007).

[142] *Starr, et al, supra* note 140.

[143] Treas. Reg. § 1.752-2(f) ex. 2 (2007).

[144] *Id*. *See also* I.R.S. Field Svs. Advice 200025018 (2000).

If members of an LLC have entered into a DRO, each member is obligated to the LLC to make up losses to the extent of the member's negative basis in the event of a bankruptcy. The LLC, and therefore its creditors, may enforce an executed DRO against a member. New Mexico statutory liability for contribution provides that a written promise (e.g., a DRO) to an LLC to contribute is not excused by death, disability, or inability to perform.[145] The New Mexico statute further provides that when winding up the affairs of an LLC, creditors have first priority when liquidating assets and rights to collect under a DRO.[146]

### H. Ability to Allocate Income, Deduction, Loss, and Credit

S corporations are subject to a single level of income taxation, which is reflected on each shareholder's personal income tax return. Each shareholder must separately account for his or her pro rata share of the entity's corporate items of income deduction, loss, and credit on the shareholder's personal tax return.[147]

Unlike LLC allocations, S corporation allocations may not be varied by agreement of the equity holders; they must be allocated in proportion to shares of stock owned. This can result in allocations of depreciation expense to shareholders other than the shareholder who contributed appreciated property in a manner that could not be accomplished in an LLC.[148]

Like S corporations, LLCs are also subject to a single level of income taxation. Items of income, gain, deduction, loss, and credit are allocated or separately stated to each individual shareholder in accordance with Code provisions and regulations. Like a partnership, an LLC may allocate items of income and expense in a manner that is disproportionate with ownership interests.[149] LLC allocation may be 1) in proportion to contributions to the LLC, 2) based on any agreed distribution of profits, or 3) on any other basis that has "economic significance independent of the tax consequences."[150]

Disproportionate allocation of LLC items of income, gain, loss, and deduction will be respected provided that the allocation meets one of the following tests: 1) the allocation has substantial economic effect; 2) the allocation is in accordance with the members' interest in the LLC; or 3) the allocation is deemed to be in accordance with member's interest in the LLC.[151] An allocation agreement also has substantial economic effect if it meets the Regulation's safe harbor requirements that: 1) the LLC must establish and maintain capital accounts for the members in accordance with principles of financial accounting;[152] 2) upon liquidation of the LLC or of any member's interest in the LLC, liquidating distributions must be made in accordance with the positive capital account balances of the members after considering capital account adjustments for the LLC's taxable year in which the liquidation occurs;[153] and 3) if a member's capital account has a deficit balance following liquidation of the member's interest in the LLC, the operating agreement must provide that the member is unconditionally obligated to

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[145] N.M. STAT. ANN. § 53-19-21.
[146] *Id*. § 53-19-44.
[147] I.R.C. § 1366(a) (2007). *See also* Treas. Reg. § 1.1366-1(a) (2007).
[148] *See, e.g.,* Mathew A Melone, *Limited Liability vs. S Corporation*, 57 TAX'N FOR ACCT. 12 (1996).
[149] I.R.C. § 704(a) (2007).
[150] Treas. Reg. § 1.704-1(b)(2)(2007).
[151] *See* I.R.C. § 704(a),(b) (2007); Treas. Reg. § 1.704-1(b)(1)(i) (2007).
[152] Treas. Reg. § 1.704-1(b)(2)(iv)(2007); *see also,* Rev. Rul. 92-97, 1992-2 CB 124.
[153] Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (2007).

restore the amount of such deficit balance to the LLC by the end of the taxable year (or within 90 days of liquidation if the date is later).[154]

The accounts must show that a member who receives the economic benefit of an allocation also bears the burden of the allocation. As an alternative test for economic effect, an operating agreement may substitute a qualified income offset provision, under which a member who receives an adjustment that causes the basis to be negative is allocated income and gain to eliminate the deficit capital account balance as quickly as possible.[155] This provides a safe harbor for allocations but does not create debt that is recourse to the member.

Both LLC members and S corporation shareholders may deduct losses to the extent that the equity holder has a positive basis in the corporation.[156] LLC deductions and losses are passed through to members on whatever Service allowed method members choose. Such flexibility permits LLC members to allocate losses to members whose personal tax position permits them to utilize the losses most effectively.[157] S corporation losses may not be allocated in a manner that takes equity holders' individual tax positions into account. The allowable allocation method is fixed by statute.[158]

## I. Tax Treatment of Property Distributions to S Corporation Equity Holders

A property distribution from an ongoing S corporation to shareholders is likely to be taxable. When property is distributed, the value of the distribution is the fair market value of the property at distribution.[159] To the extent that the property distributed has appreciated, the S corporation recognizes gain on distribution of appreciated property equal to the gain that would be recognized were the property sold to the recipients at fair market value.[160] The gain is passed through and is taxable to shareholders as increased profits to the S corporation.[161] The recipients of the property are treated as receiving property with basis equal to the fair market value of the property.[162] A partial distribution of an ongoing S corporation's property to shareholders is treated as a dividend to the extent of any earnings and profits (undistributed earnings and profits, which may have been created during existence of the corporation as a C corporation prior to its conversion to an S corporation). Anything in excess is treated as a return of

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[154] *Id.* § 1.704-1(b)(2)(ii)(b)(3) (2007).

[155] *Id.* § 1.704-1(b)(2)(ii)(d), ex. 6 (2007).

[156] Basis consists of initial investment, plus increases for income items including tax exempt income, less
decreases for distributions, deductions, and losses. For S corporations the rules are found at I.R.C.
§§ 1367(a)(1) (2007) [ increases in basis], (2)[decreases in basis]; Treas. Reg. § 1.1367-1(a)(b) (2007).
*See also*, "Special Rules for Losses and Deductions," I.R.C. § 1366(d)(1) (2007); Treas. Reg. § 1.1366-2
(2007). For LLCs, the rules are found at I.R.C. § 705 (2007); Treas. Reg. §§ 1.705-1, 1.705-2 (2007).

[157] I.R.C. § 704(a) (2007) and the extensive regulations found at Treas. Reg. §§ 1.704-1(b)(1), (2) , and discussed herein, explain the many alternatives available to LLC members.

[158] *Id.* § 1366.

[159] *Id.* § 301(b) (2007). If the property is encumbered with a liability the value is fair market value less
the liability, I.R.C. § 301(b)(2) (2007).

[160] *Id.* § 311(b) (2007).

[161] *Id.* § 1363 (2007), *see id.* § 311(b) (2007).

[162] *Id.* § 301(d) (2007).

capital that reduces shareholder basis.[163] If the property distributed has a basis less than the encumbrance, the value of the property at distribution is treated as being the amount of the liability.[164]

A property distribution from an S corporation at its termination (when the S corporation ceases to be a going concern and its activities are limited to winding up its affairs) is treated similarly.[165] The corporation recognizes loss or gain on distribution of property to shareholders in a complete liquidation.[166] Shareholders treat property received in liquidation of the corporation as taxable proceeds received in exchange for their stock. The fair market value of property distributed to the shareholder, less adjusted basis in the stock surrendered, is the shareholder's gain or loss.[167] Unless the shareholder is a trader in stock, the gain or loss is capital gain or loss.[168] If distributions in a complete liquidation are disproportionate with share ownership, shareholders receiving more than a proportionate share are treated as receiving a payment from the shareholders who receive less than their proportionate share.[169]

Generally, neither non-liquidating nor liquidating distributions of money or other property results in recognition of gain except for disproportionate distribution of Section 751 assets (substantially appreciated inventory and accounts receivable).[170] Distributions to LLC members, as opposed to allocation of LLC income to members as taxable income, are made in accordance with the terms of the operating agreement. Distributions reduce the LLC member's outside basis in the LLC.[171] If a member receives a transfer of cash in excess of a member's outside basis in the LLC, the member recognizes gain. However, the member does not recognize gain if the member receives cash and assets and the cash is not in excess of basis regardless of the fair market value of the assets.[172] Cash is deemed to be distributed first, then other assets,[173] permitting the member to take a reduced basis in the other assets rather than recognize income so long as the cash received does not exceed basis. When cash received is in excess of basis, the gain is usually capital gain.[174] The transfer of marketable securities is treated like cash and is taxable to the member to the extent that the value exceeds a member's outside basis in the LLC.[175] When inventory or receivables are received,[176] the amount received in excess of the basis in those assets can be ordinary income.[177] Reduction of LLC debt that is recourse debt with respect to the member is treated the same as a cash withdrawal that reduces a member's outside basis.[178]

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[163] *Id*. § 1368(e) (2007).
[164] *Id*. § 311(b)(2) (2007).
[165] Treas. Reg. § 1.332-2(c) (2007).
[166] I.R.C. § 336 (2007).
[167] *Id*. § 334(a) (2007).
[168] *Id*. § 336(a) (2007).
[169] Rev. Rul. 79-10, 1979-1 C.B. 140.
[170] I.R.C. §§ 731(a), 751 (2007).
[171] *Id*. § 733 (2007).
[172] *Id*. § 731(a)(1) (2007).
[173] *Id*. § 733 (2007).
[174] Treas. Reg. § 1.l731-1(a)(3) (2007).
[175] I.R.C. § 731(c)(1) (2007). *See also* I.R.C. § 731(c)(3)(b) (2007), Treas. Reg. § 1.731-2(b)(2) (2007) (describing computing gain).
[176] I.R.C. § 751 (2007).
[177] *Id*. § 731 (2007). This discussion does not address the tax consequences of a disguised sale masquerading as a distributions that is addressed by I.R.C. § 707(a)(2)(b), directly reciprocal disguised sales—2 year rule, I.R.C. §737 directly reciprocal disguised sales—7 year rule, or I.R.C. § 704(c)(1)(b) indirectly reciprocal sales.
[178] Treas. Reg. § 1.731-1(a)(1)(ii) (2007). I.R.C. § 731(a)(1) (2007). It is subject to the netting rules of Treas. Reg. § 1.752-1(f) (2007).

At termination of the LLC, loss recognition is permitted only if the terminating distribution is 1) in complete liquidation of the member's interest in the LLC, 2) composed only of cash (including marketable securities), unrealized receivables, and/or inventory, and 3) valued at more than the member's outside basis.[179] If the value is less than the member's basis, distribution of other assets is generally not a taxable event.[180] A disproportionate distribution (i.e., a distribution other than proportional with member ownership interests) of Code § 751 assets in either a non-liquidating or a liquidating distribution to a member is recharacterized by the Service. The Service treats the distribution as if the member had sold a portion of other than Section 751 assets to the LLC in exchange for the member purchasing the disproportionate share of the Section 751 assets. The deemed sale of Section 751 assets to the member creates ordinary income for the LLC. The deemed sale also creates capital gain (or loss) for the member, measured by the value of the excess of the member's proportionate share of Section 751 assets received in exchange for the share of the other property that the member was deemed to have relinquished.[181] If the member receives a more than proportionate distribution of other property, and therefore a less than proportionate distribution of Section 751 assets, the member is treated as selling Section 751 assets to the LLC and receiving ordinary income. The member is deemed to have purchased a share of other assets in exchange.[182]

Payments to a retiring member or a deceased member's estate are not treated as a sale or exchange between the member and the LLC to the extent that such payments constitute either a distributive share of LLC income or guaranteed payments.[183] When an LLC interest is sold, it is treated as sale of a capital asset; however, the portion reflecting gain on Section 751 assets is treated as ordinary income.[184]

## IV. S CORPORATION AND LLC EMPLOYMENT TAX RULES

The portion of S corporation income that reflects work performed by shareholders functioning as employees of the corporation is subject to employment tax.[185] In other words, shareholders who provide service to the corporation are expected to pay employment tax on the payments received for the value of their services. The undistributed taxable income passed through to S corporation shareholders as return on their equity investment is not included in employment earnings.[186] The portion of S corporation income earned by shareholders that is subject to employment tax is determined either by reference to earnings of comparable employees in other firms or

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[179] I.R.C. § 731(a)(2) (2007). Rules for recognizing loss in a proportionate liquidating distribution are provided at I.R.C. § 751(d)(2) (2007).

[180] *Id*. § 731(a)(2) (2007); *Id*. § 731(c)(1) (2007).

[181] I.R.C. § 751(b)(1) (2007); Treas. Reg. § 1.751-1(b)(2), (3) (2007).

[182] The disproportionate distribution rules do not apply to the distribution of property to a member that was previously contributed by the member to the LLC; I.R.C. § 751(b)(2)(A) (2007); Treas. Reg. § 1.751-
1(b)(4)(i) (2007).

[183] Treas. Reg. § 1.751-1(b)(4)(ii) (2007).

[184] *See* Treas. Reg. § 1.751-1(a)(2) (2007) (describing computation of ordinary and capital gain).

[185] *See generally*, Patrick McCarthy, *Reduce Self-Employment Tax on LLC Income*, 74 PRAC. TAX STRATEGIES 3 (2005); Dean B. Cross, *Limited Liability Companies and the Self-Employment Tax*, New Mexico State Bar Annual Meeting (Jul. 12-15, 2007).

[186] Rev. Rul. 59-221, 1959-1 C.B. 225. Nu-Look Design, Inc. v. Comm'r, T.C.M. 2003-52, *aff'd*, 356 F.3d 290 (3d Cir. 2004); Durando v. United States, 70 F.3d 548, 552 (9th Cir. 1995).

based on what an independent owner would be willing to pay for the services.[187] A dividend to a passive shareholder is not subject to employment tax. Neither is the return to shareholders actively working in the enterprise in excess of the value of their labor.

These same principles apply to partners in a limited partnership. Employment taxes must be paid on all distributions paid to general partners in a partnership since they are, by definition, active participants in the business. Employment taxes are not paid on distributions paid to limited partners since Congress has provided that limited partners are not self-employed and therefore could not pay employment taxes.[188] Under the revised Uniform Limited Partnership Act, a partner may own both a general partnership interest and a limited partnership interest.[189] Whether a partner is a limited partner or a general partner is determined by whether the partner has the right to act for or bind the partnership.[190] The Regulations provide an exemption from employment tax on limited partnership interests for partners who hold both general and limited interests in the entity, providing the general partner's limited interest is the same as that of all other limited interest holders.[191]

Under the Service's 1997 proposed regulations on employment taxes imposed on LLC members,[192] an LLC member is treated as a limited partner unless the member 1) has personal liability for the debts of the LLC,[193] 2) has authority to contract on behalf of the LLC,[194] or 3) participates in the trade or business for more than 500 hours a year.[195] A member who does not have authority under the operating agreement to contract for the LLC may be classified as a limited partner,[196] as may an LLC member who owns both a manager interest and a non-manager interest.[197] The LLC operating agreement may provide for two classes of membership interests and allocate returns among membership interests in the different classes to reflect earnings from employment that

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[187] Radtke v. United States, 895 F.2d 1196 (7th Cir. 1990) (wages subject to self employment tax are wages that would be paid in a corporation to an employee for work of a similar type); Exacto Spring Corp. v. Comm'r, 196 F.3d 833 (7th Cir. 1999) (income subject to employment tax is amount an independent investor would be willing to compensate employee).

[188] I.R.C. § 1402(a)(13) (2007) ("there shall be excluded [from employment tax] the distributive share of
any item of income or loss of a limited partner, as such, other than guaranteed payments . . . "). S*ee also,*
H.R. Rep. No. 95-702, pt. 1, at 40 (1977) (which explains that the provision was passed to prevent limited partners to pay employment tax so as to qualify for social security).

[189] *See, e.g.,* New Mexico's Uniform Revised Limited Partnership Act, which specifically provides that a member of a New Mexico limited partnership may have both general partner and limited partner interests. 2007 N.M. Laws 129; 2007 N.M. Ch. 129 §113, to become effective on Jan. 1, 2009 and to be codified at N.M. STAT. ANN. § 54-2A-113. (The Revised Uniform Partnership Act was passed in 2007 and becomes effective on Jan. 1, 2009).

[190] N.M. STAT. ANN. § 54-2-20, replaced by 2007 N.M. Laws 129; 2007 N.M. Laws 129; 2007 N.M. Ch. 129 § 302 and to be codified at N.M. STAT. ANN. § 54-2A-302 ("A limited partner does not have
the right or the power as a limited partner to act for or bind the limited partnership") (The Revised
Uniform Partnership Act was passed in 2007 and becomes effective on Jan. 1, 2009).

[191] Prop. Treas. Reg. § 1.1402(a)-2(h)(3)-(5), 62 Fed. Reg. 1702 (Jan. 13, 1997).

[192] *Id.* § 1.1402(a)-2(h)

[193] *Id.* § 1.1402(a)-2(h)(2)(i).

[194] *Id.* § 1.1402(a)-2(h)(2)(ii).

[195] *Id.*

[196] *Id.* § 1.1402(a)-2(h)(2)(i-iii).

[197] *Id.* § 1.1402(a)-2(h)(3).

is subject to employment tax and earnings from passive ownership that is not. If the members choose such a structure, the employment tax result is the same for an LLC as it is for an S corporation (at least until the proposed rules are changed by the Service or by Congress).

## V. CONCLUSION

Shareholders of an existing C corporation are more likely to minimize adverse tax consequences by converting to an S corporation than by converting to an LLC.[198] Similarly, shareholders in an existing S corporation may incur tax liability if they convert to an LLC.[199] In a few instances, allocation of deductions may be preferable if the equity investors form an S corporation rather than an LLC. Subject to those exceptions, the above analysis demonstrates that forming an S corporation will seldom provide the benefits to equity investors that forming an LLC can provide. Absent a few special circumstances, there is no principled basis on which attorneys or accountants can recommend an S corporation rather than an LLC.

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[198] *See generally,* I.R.C. § 368(a) (2007), Treas. Reg. §§ 1.368-1, 1.368-2 (2007).

[199] I.R.C. § 336(a) (2007). A shareholder treats property received in liquidation as proceeds obtained from
the exchange of stock valued at fair market value, I.R.C. § 331 (2007).