

S-CORP LLCs - PLANNING OPPORTUNITY OR SOLUTION IN SEARCH OF A PROBLEM?

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At the recently completed Young Lawyer Institute in Vancouver we were among the presenters at the program *Understanding LLC Operating Agreements – How the Deal Affects Drafting*.³ In the course of the program we were asked, *inter alia*, why would anyone have an LLC make an S-election? Frankly, we were not able to provide much in the way of a complete and balanced answer as, well, there seems to us to be very little to recommend that format. We hope that the following thoughts are a rather more complete answer to the question presented.⁴

The S-Corp LLC - Mixing State and Tax Law

Let's be sure we are clear as to what it is we are discussing. An LLC is an unincorporated business organization having at least one owner called a "member." The agreement that governs the operation of the LLC is the "operating agreement."

Under the so-called "check-the-box" classification regulations adopted as of January 1, 1997, unincorporated business organizations are "eligible entities" that may elect how they would like to be "classified" for Federal tax purposes. Classification is the mechanism by which a particular form of organization will be taxed is determined, typically under Subchapter C (the default treatment of "corporations"), Subchapter K (classification as a partnership) or Subchapter S (small business corporation or "S-Corp."). While a corporation is automatically subject to Subchapter C, and if eligible to do so may elect to be an S-corporation, an unincorporated entity has a default classification as a partnership subject to Subchapter K so long as it has at least two owners or as a "disregarded entity" if it has only a single member.⁵

An LLC that has either one or multiple members may elect to be classified as a corporation, and from there (assuming such is permissible) make an election to be classified as an S-Corp. The initial election for an LLC to be classified as a corporation for tax purposes is

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³ The other presenters were James J. Wheaton of Troutman Sanders (Virginia Beach, Virginia) and Cristin C. Keane of the Tampa office of Carlton Fields. Jim is the chair of the Committee on LLC, Partnerships and Unincorporated Entities and Cristin is the Co-Chair of Membership of the Committee on LLCs, Partnerships and Unincorporated Entities.

⁴ Another review of these issues appears that Robert R. Keatinge, *LLCs and Limited Partnerships as S-Corporations*, presented at LIMITED LIABILITY ENTITIES: NEW DEVELOPMENTS IN LIMITED LIABILITY COMPANIES AND LIMITED LIABILITY PARTNERSHIPS (March 17, 2005).

⁵ The Check-the Box regulations appear at Treas. Reg. § 301.7701 et seq.

done on Form 8832, Entity Classification Election.⁶ If S-Corp. status is as well desired, that election is made on Form 2553, Election by a Small Business Corporation.⁷

It is important to understand that one does not organize an S-Corp. Rather, the status as an S-Corp. is elected by a business organization that is otherwise taxed as a corporation. Not only may a traditional state law corporation elect S-Corp. status, but that same election may be made by an LLC, irrespective of whether it is a single or a multiple member LLC, a limited partnership or any other form of business organization that, in a particular instance, satisfies the requirements for S-Corp. status that are set forth in the Internal Revenue Code at § 1361(b). As such, when the provisions of the Internal Revenue Code and its regulations discuss an “S-Corp.,” they are referring to a business organization that is taxed as a corporation and which has made an election under Internal Revenue Code § 1362 to be an S-Corp.; there is no requirement that the organization in question had been organized as a corporation for state law purposes.

But Why?

It is possible for an LLC to be taxed as an S-Corp. But just because it can be done does not mean that it should be done. Rather, this structure should be utilized only if it responds to a need, only if it resolves a particular set of problems. If it does not, it is an answer in search of a problem.

The questions presented are at least two: (a) what are the advantages of state law organization as an LLC rather than as a corporation; and (b) what are the benefits of S-Corp. taxation over Subchapter K that warrant the election?

One aspect of the LLC that is not available in the corporation is the “charging order,” the provision of LLC law that provides that a judgment creditor of a member may in effect garnish the distributions made by the LLC to the member, but may not otherwise insert themselves into the operation of the LLC.⁸ The availability of the charging order is often trumpeted by those involved in “asset protection” who posit that the charging order makes it less likely that a judgment creditor will be able to collect and for that reason they are more likely to either abandon the claim or settle at a reduced rate. Whether such an asset protection objective should be a significant issue in the choice of entity calculus is certainly open to question.⁹ Furthermore,

⁶ No Form 8832 is necessary if the unincorporated entity desires its default classification; it is not necessary to affirmatively elect into that default classification.

⁷ Treas. Reg. § 301.7701-3(c)(1)(v)(C) provides, that an eligible entity desiring S-Corp. status may file Form 2553 which will be deemed to constitute as well an election of corporate classification as would otherwise be made on Form 8832.

⁸ For a general review of the charging order, see Thomas E. Rutledge, *Charging Orders: Some of What You Ought to Know (Part I)*, 9 J. PASSTHROUGH ENTITIES 15 (Mar./Apr. 2006); *(Part II)*, 9 J. PASSTHROUGH ENTITIES 9 (Jul./Aug. 2006); see also Thomas E. Rutledge, Carter G. Bishop and Thomas Earl Geu, *Foreclosure and Dissolution Rights of a Member's Creditors: No Cause for Alarm*, 21 PROPERTY & PROBATE 35 (May/June, 2007).

⁹ With one exception, the charging order is uniquely a component of unincorporated business law and is absent from business corporation law. That one exception is Nevada, which has a charging order provision for certain corporations in its business corporation act. One of us has argued, however, that this provision is

as an asset protection vehicle, the charging order will likely not be effective in a single member LLC.¹⁰

A perhaps more valid basis for choosing, within the context of an anticipated S-Corp. classification election, to be organized as an LLC is the greater flexibility with respect to organizational structure. As a general rule, the corporate structure rules are mandated by the statute and are not modifiable by private ordering, rules which include the requirement that there be a board of directors, that the board of directors designate at least one officer, namely the secretary, that there be a minimum of two days notice of any meeting of the board of directors, that there be an annual meeting of the shareholders, that there be provided a minimum of ten days notice for any meetings of the shareholders, and that significant organic transactions such as a merger proceed only with the approval of the board of directors.¹¹ While these rules are subject to a limited degree of modification in those few states that have adopted the Close Corporation Supplement to the Model Business Corporation Act, that degree of flexibility is still significantly less than that permitted under the equivalent LLC Act.

Another basis for choosing the LLC over a corporation may involve questions of professional regulation. Many professions may be practiced in the corporate form if and only if the corporation is as well subject to the professional corporation supplement as affect in the various states, which statutes have the effect of mandating certain requirements with respect to the directors and officers of the corporation, permissible shareholders and certain mandatory redemptions. In many of these states, while there is a professional service corporation supplement in place, similar limitations do not apply to LLCs that are organized to render professional services.¹²

In addition to choosing the LLC format over the corporate format, there is the question of why to choose taxation under Subchapter S over taxation under Subchapter K.¹³ Determining whether, at least on a pro-forma basis, Subchapter S or Subchapter K is preferable is a rather involved process, especially in the context of a professional practice or other business in which capital is not a material income producing item.¹⁴ Conversely, in businesses in which capital is a material income producing item, such as real estate development, often the advantages of

ineffective. See Thomas E. Rutledge, *Nevada's Corporate Charging Order: Less there than Meets the Eye*, 11 J. PASSTHROUGH ENTITIES 21 (Mar./Apr. 2008).

¹⁰ See Thomas Earl Geu and Thomas E. Rutledge, *The Albright Decision – Why a SMLLC is not an Appropriate Protection Vehicle*, 5 BUSINESS ENTITIES 16 (Sept./Oct. 2003).

¹¹ Model Business Corporation Act §§ 8.01, 8.40(c), 8.22(b), 7.01(a), 7.05(a) and 11.04(a).

¹² See generally Thomas E. Rutledge, *The Place (If Any) of the Special Purpose Professional Structure in Entity Rationalization*, 58 BUSINESS LAWYER 1413 (Aug. 2003).

¹³ We here assume that the entity in question has at least two (2) members; a single member organization may not elect to be taxed under Subchapter K. Note, however, that a single owner organization that is otherwise eligible may elect to be taxed as an S-Corp.

¹⁴ For a review of the pro-forma comparison of Subchapter C, Subchapter S and Subchapter K in the context of a professional practice and an illustration of the complexity of this analysis, see Thomas E. Rutledge, Stephen M. Lukinovich and Mark S. Franklin, *Organizing a Professional Practice: An After-Tax Choice-of-Entity Calculus*, 110 J. TAX'N 135 (Mar. 2009).

Subchapter K will significantly trump those of Subchapter S and Subchapter C both as to the treatment of current distributions and as well the tax treatment upon liquidation.

There is often cited the distinction between Subchapter S and Subchapter K with respect to distributions. In an S-Corp., a certain amount of the distributions that would be made may be characterized as “salary” which is subject to Social Security (“SECA”) and Medicare taxes and the balance of the funds available being treated as a distribution that is not subject to those levies. Conversely, in many situations (definitive guidance from the IRS has not yet been handed down) all of the amounts distributed to a member may be subject to Social Security and Medicare taxes, and there is not the ability to subdivide those amounts between “salary” and “distributions.”¹⁵

At the same time, it needs to be recognized that S-Corp. classification imposes significant limitations that do not apply under Subchapter K. For example, many start-up ventures incur losses that are supported by debt financing. In the context of an S-Corp., failing to properly structure that debt as a personal obligation of the shareholder(s) rather than initially an obligation of the business organization that is in turn guaranteed by the shareholder limits the deductibility of losses as the latter format does not create at-risk basis. Conversely, in an LLC subject to Subchapter K, the guarantee of the debt undertaken by the business organization is sufficient to create at-risk basis against which losses may be taken.¹⁶ Additionally, the context of an organization taxed under Subchapter K, Code § 754 provides planning opportunities with respect to basis step-ups on transfers of ownership interests, a planning opportunity that does not exist with respect to an S-Corp.

What Could Go Wrong?

Simply because something can be done does not mean it should be done, especially when the degree of complexity, and consequent risk of failure, are high. While such caveats are typically applied in the context of mountain climbing and base jumping, they can apply as well in the choice of entity calculus. Classification of a business organization as an S-Corp. is dependent upon satisfaction of a number of conditions, some procedural such as the timely filing of Form 2553,¹⁷ and others more substantive, such as the limitations on permissible shareholders set forth at Code § 1361. There is especially troubling the requirement that an S-Corp. be limited to a “single class of stock.”¹⁸ A requirement that is particularly troubling in light of the usual statutory directive as to how assets will, upon liquidation of an LLC, be distributed. For example, the Revised Uniform Limited Liability Company Act (“RULLCA”), at Section 708(b), directs that after the satisfaction of creditor claims, the assets of an LLC will be distributed first amongst the holders of the economic rights therein as a return of capital contributed and that the balance of the assets will then be distributed pro-rata amongst the members, dissociated members

¹⁵ See generally ROBERT R. KEATINGE AND ANN E. CONAWAY, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY §§ 13:32 through 13:37 (West 2008).

¹⁶ See *Melvin*, 88 TC 63 (1987). But see Prop. Reg. § 1.465-16.

¹⁷ Code § 1362(b)(1). An election may be made at any time during the preceding taxable year, or on or before the 15th day of the third month of the current taxable year.

¹⁸ Code § 1361(b)(1)(D). Within the “single class” of stock there may be voting and non-voting shares that, but for that distinction as to participation of management, are otherwise economically identical.

and certain transferees. This formula for the distribution of assets upon liquidation, as applied, would violate the single class of stock rule. While this provision may be modified in the operating agreement,¹⁹ it is open to debate whether and how often S-Corp. LLC operating agreements have effectively overridden these and similar provisions of state law. The writing of an effective operating agreement for an LLC that is to elect to be an S-Corp. entails an understanding of the various requirements and limitations imposed upon S-Corps. and a willingness to review them against the entirety of the controlling LLC Act to determine where the LLC Act provides a default rule that would or could violate the requirements of S-Corp. status and, once those areas of conflict have been identified, the effective drafting within the operating agreement of an override provision. The transactional costs imposed in this effort are obvious.

Our respective practices involve significant work in choice of entity and preparation of organizational documents. While we certainly can not represent that there is no situation in which the S-Corp. LLC will not be the best option, neither of us has yet encountered that situation. As such, while the S-Corp. LLC may be conceptually possible, we continue to view it as being a solution in search of a problem.

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RULLCA § 110.