The Rising Popularity of SMLLC's in Tax and Business Planning

Single-member limited liability companies (SMLLCs) have become popular in the past decade as taxpayers take advantage of opportunities presented by the check-the-box regulations. This article examines common situations in which SMLLCs are useful and identifies some potential pitfalls with their use.

Ryan H. Pace, M.Tax., J.D., LL.M.
Assistant Professor of Accounting
Weber State University
Ogden, UT
Of Counsel
Holland & Hart LLP
Salt Lake City, UT

For more information about this article, contact Mr. Pace at rpace@weber.edu.

A decade has now passed since the check-the-box (CTB) regulations became effective. Tax and business planners have taken advantage of the flexibility provided by the regulations to structure a wide variety of transactions. Perhaps the most beneficial tax and business planning opportunity encouraged by the CTB regulations is the use of the single-member limited liability company (SMLLC). This article provides a brief overview of the law in this area, then discusses some common situations in which the SMLLC has become an entity of choice. It concludes by identifying some potential pitfalls regarding the use of SMLLC's.

State LLC Law

If an LLC is properly organized and operated, state laws afford liability protection to the LLC's owners. State LLC laws also generally provide significant operational flexibility for LLC's that is not generally available to corporations. For instance, LLC's may be managed by one or more managers or by the members. In addition, state LLC laws are often not as stringent compared with corporate laws on shareholder and board meetings, etc., which may appeal especially to LLC's with few owners. State laws also allow an LLC to have only one owner, a benefit not available to partnerships.

With the favorable Federal income tax treatment and the flexibility afforded LLC's under state law, it is not surprising that the number being formed has increased significantly in recent years. For example, new LLC filings in Arizona increased from 32,662 in 2004 to 57,017 in 2006—a

75% increase over that period. Other states have also experienced dramatic increases in LLC filings.

Check-The-Box Regulations

The emergence of LLC's as a popular choice in the late 1980s and early 1990s was undoubtedly an important factor causing the IRS to closely examine how various entities should be taxed for Federal income tax purposes. The law on the tax treatment of entities at that time had evolved primarily from the *Morrissey* case in 1935. In that case, the Supreme Court held that, if a business entity had at least three of the following four characteristics, it was taxed as a corporation for Federal income tax purposes: continuity of life, free transferability of interest, centralized management and limited liability for owners.

The CTB regulations changed the entity-classification system dramatically. Under Regs. Sec. 301.7701-3(a), by default, an entity incorporated under state law is taxed as a corporation. Further, an entity not incorporated under state law is generally taxed as a partnership if it has more than one owner and as a "disregarded entity" (DE) if it has only one owner. The alternative to the default classification for unincorporated entities is to "check the box" on Form 8832, Entity Classification Election, to notify the IRS that the entity elects to be taxed as a corporation. Under Regs. Sec. 301.7701-2(a), the consequence of being classified as a DE is that the entity is treated as if it does not exist separately from its owner for Federal income tax purposes; the DE's sole owner reports all the entity's income, gain, loss, expense, etc., directly on the owner's tax return. As a result, an SMLLC is considered a "tax nothing" under the Federal income tax regulations if the LLC does not check the box to be treated as a corporation. Not surprisingly, taxpayers and their advisers have found many creative ways to use SMLLC's.

Real Estate

Investing

Real estate investors usually desire personal liability protection from their real estate activities. Moreover, investors that own more than one property usually want to isolate potential liability exposure for each property. Before the advent of LLC's, a real estate investor would generally have to form a corporation or limited partnership (LP) to gain personal liability protection. Of course, the disadvantage of a corporation is the double taxation of its income. Even an S corporation provides limits that real estate investors may find prohibitive (e.g., the limit on eligible shareholders, one-class-of stock requirement, gain recognition on the corporation's distribution of appreciated property and tax on excess net passive income).

Partnerships also pose some potential problems. An LP must have at least two partners, with at least one serving as general partner. With an SMLLC, the investor not only gets liability protection but can also be the entity's sole owner. Unlike an S corporation, there is no limit on who can own an interest in an SMLLC.

> ***Example 1:*** *R*, a real estate investor, wants to acquire two rental properties. *R* would also like to be protected from personal liability as to the properties and would like each property to be isolated from the other's liabilities. *R* forms two SMLLC's and places one property in each. *R* does not elect to check the box to have the SMLLC's treated as corporations for Federal income tax purposes. As a result of these transactions, *R* reports the SMLLCs' activities directly on his income tax return.

Like-Kind Exchanges

SMLLC's have evolved into an important part of Sec. 1031 deferred-exchange transactions. Under Sec. 1031(a)(3), once the taxpayer has disposed of the relinquished property, the taxpayer has 45 days to identify a replacement property and 180 days to acquire it. If the taxpayer receives property (including cash) in an exchange that is not of like kind, the Sec. 1031 gain-deferral provisions do not apply, according to Sec. 1031(b). Thus, "qualified intermediaries" (QI's) typically become involved, so the taxpayer does not directly receive nonqualified property from the buyer. These QI's often accommodate the exchange by creating SMLLC's to receive cash and/or properties held as part of the deferred like-kind exchanges until the exchange is complete. The IRS has ruled that a like-kind exchange accommodator's use of a DE as titleholder to exchange properties will not disqualify the transaction. At the same time, the SMLLC provides the accommodator (the SMLLC's sole owner) with liability protection under state law.

SMLLC's are also commonly used in "reverse" Sec. 1031 deferred exchanges. In a reverse exchange, a taxpayer acquires the replacement property before disposing of the relinquished property. Rev. Proc. 2000-37 explains how a typical reverse exchange occurs. In short, the taxpayer "parks" the replacement property with a QI or "exchange accommodation titleholder" until the taxpayer can dispose of the relinquished property within the allowed period. The exchange accommodator will most likely set up a special-purpose entity (usually an SMLLC) to hold the parked property for the taxpayer until the exchange is complete. If done properly, this structure—using the SMLLC—not only protects the exchange accommodator from the potential liabilities associated with the parked property, but also eliminates a significant number of the tax and non-tax problems that an S corporation, a C corporation or a partnership would create if those entities were the only choices available to the exchange accommodator.

C Corporations

Separate Divisions

If a corporation is the sole owner of an SMLLC, Regs. Sec. 301.7701-2(a) will treat the SMLLC as merely a division of the corporation for Federal income tax purposes. Consequently, corporations may choose to transfer certain business activities into SMLLC's for liability protection purposes without facing the administrative hassles and expenses that may arise with forming and governing corporate subsidiaries. Moreover, by forming SMLLC's, a parent corporation can avoid the often-complex provisions found in subchapter C and elsewhere in the tax law dealing with controlled groups, affiliated groups, consolidated returns, etc.

Reorganizations

SMLLC's can also be involved in corporate reorganizations. Treasury has clarified how a DE's involvement in a statutory merger does not disqualify the merger as a tax-free reorganization.

> ***Example 2:*** *T* Corp. merges into an SMLLC (a DE), with the SMLLC surviving. The SMLLC is owned solely by *A* Corp. The *T* shareholders receive *A* stock
>
> .

In Example 2, the merger is tax free as long as the other requirements of Sec. 368(a) (2)(D) are met. SMLLC's may also be used as part of other types of reorganizations qualifying under Sec. 368.

> ***Example 3:*** *P* Corp. owns *S* Corp. *S* creates an SMLLC; the SMLLC acquires control (as defined by Sec. 368(c)) of a target corporation by exchanging *P* stock for the target's stock.

As long as the other reorganization requirements are met, the fact that the SMLLC used *P* stock in the reorganization does not disqualify the transaction as a valid B reorganization.

Conversions of SMLLC's into C Corporations

If an SMLLC desires to be taxed as a C corporation, it need only check the box on Form 8832. The conversion to a C corporation is treated as a corporate formation for income tax purposes, under Regs. Sec. 301.7701-3(g)(1)(iv). Consequently, Sec. 351 applies in determining whether the deemed transfer of assets to a corporation is nontaxable.

In the reverse situation, if an otherwise eligible entity currently being treated as a C corporation elects to be treated as a DE, the election is deemed to be a complete liquidation of the C corporation, under Regs. Sec. 301.7701-3(g)(1)(iii). In this case, if the sole owner is a corporation, the complete liquidation would not trigger gain or loss recognition because of the parent-subsidiary liquidation rules in Secs. 332 and 337.

> ***Example 4:*** *P* Corp. owns an SMLLC. More than five years ago, the SMLLC elected to be taxed as a corporation under the CTB rules. It owns only one asset, land worth $100 (adjusted basis $40), and now elects to be taxed as a DE.

For Federal income tax purposes, the conversion of the SMLLC from a C corporation to a DE will be a deemed complete liquidation of a C corporation, which under Sec. 336(a) would trigger a $60 gain to the SMLLC. But because *P* is a corporation that owns at least 80% of the SMLLC, Sec. 337(a) dictates that the SMLLC will not recognize the $60 gain.

S Corporations

Eligible Shareholder

For a corporation to qualify as an S corporation for Federal income tax purposes, it is allowed to have only certain "eligible shareholders," under Sec. 1361(b)(1)(B). For example, corporations, partnerships and LLC's (taxed as partnerships) are not eligible S shareholders. However, what are the consequences if an SMLLC disregarded for Federal income tax purposes becomes an S shareholder? The IRS has ruled that the disregarded SMLLC will not itself be treated as the owner; rather, the SMLLC's owner will be considered the owner of the S corporation. As a result, if the SMLLC's sole owner is an eligible S shareholder, having the SMLLC own the S stock will not cause the S election to terminate.

Partnerships

Conversion from Partnership to DE

Before the emergence of the LLC, if one partner purchased the interest of the only other partner in a partnership, the partnership would dissolve under state law because there would be only one remaining partner. With the possibility under state law of an LLC having only one owner, the LLC does not dissolve even though it has only one member. The IRS has provided guidance when a multi-member LLC becomes an SMLLC as a result of one person acquiring 100% ownership of the LLC. Rev. Rul. 99-6 holds that the seller(s) of the LLC interest must treat the transfer as a sale of a partnership interest for tax purposes. The buyer is treated as purchasing each selling member's proportionate share of the LLC's assets.

> ***Example 5:*** *A* and *B* are equal partners in *AB*, an LLC. *A* sells his entire interest in *AB* to B for $10,000. After the sale, the business is continued by the LLC, which is owned solely by *B*.

In Example 5, *AB* terminates for Federal income tax, but not for state law, purposes. *A* is treated as selling a partnership interest. In determining the tax consequences to *B*, *AB* is deemed to have distributed all of its assets to *A* and *B*; *B* is treated as purchasing the assets distributed to *A*.

Rev. Rul. 99-5 addresses the converse of Rev. Rul. 99-6: If the owner of an SMLLC sells a portion of his or her interest to another person, the entity becomes a partnership for income tax purposes.

> ***Example 6:*** *A* is the sole owner of an SMLLC. *B* purchases 50% of *A*'s ownership interest for $5,000. *A* and *B* continue to operate the entity.

In Example 6, the SMLLC is converted to a partnership for Federal income tax purposes. *B*'s purchase of half of *A*'s LLC interest is treated as a purchase of a 50% interest in each of the LLC's assets, which are treated as held by *A* for Federal income tax purposes. *A* and *B* are then deemed to have contributed the assets to a partnership in exchange for partnership interests. Consequently, on the deemed transfer of assets to a partnership, Secs. 721, 722 and 723 apply in determining gain or loss recognized by each member, each member's basis in his or her membership interest and the LLC's basis in each of the assets contributed.

Liabilities and SMLLCs

An SMLLC often serves as the general partner in an LP to provide liability protection to the SMLLC's sole owner, who would otherwise serve as the general partner. Treasury has recently addressed one area of uncertainty by issuing regulations on calculating a partner's basis in the partnership if the partnership interest is owned through a DE. Generally, a partner's basis in his or her partnership interest (i.e., outside basis) is increased by the partner's share of partnership liabilities, under Sec. 752(a). Different rules apply depending on whether the liabilities are recourse or nonrecourse, however. For recourse liabilities (i.e., the partner bears the economic risk of a partnership liability), the question arises as to whether the owner of an SMLLC serving as the general partner has any economic risk as to partnership liabilities. The regulation states, in short, that a partner is treated as bearing the economic risk of loss for the liability to the extent of the DE's "net value."

Community Property
Although a partnership consisting of only a husband and wife is considered a partnership for income tax purposes, the IRS has provided an exception in Rev. Proc. 2002-69 for a husband and wife who form an LLC in a community property state, with community property. The Service indicated that if the husband and wife treat the LLC as a DE, the IRS will accept that reporting position. In contrast, if the husband and wife report the LLC's activities as a partnership, the Service will respect that, too. Any change in reporting position will be treated as a conversion of the entity from a partnership to a DE or vice versa. The scope of this ruling was only for LLC's formed with community property.

Nominal Owners
In some instances, an LLC may be formed with more than one member, but only one member has an economic interest in the LLC's profits and losses. The other member or members may be owners solely for voting purposes or making the entity bankruptcy-remote under state law. In such a situation, the IRS has ruled that the entity will still be classified as a DE in which only one owner has an economic interest. In other words, it will ignore the nominal partner for income tax purposes.

Letter Ruling 200201024 discusses such a situation. The taxpayer formed an LLC in which the taxpayer would have 100% of the economic interest, but a second member would be added for reasons other than to share in the LLC's economic interest. Rather, the second member's only rights were to help prevent the LLC's bankruptcy by requiring that member's approval before the LLC (1) filed for bankruptcy, (2) dissolved or liquidated, (3) amended the certificate of formation, (4) engaged in a business other than that specified in the certificate of formation or (5) entered into a borrowing outside the ordinary course of business. The IRS ruled that the existence of the nominal, noneconomic member did not cause the entity to be classified as a partnership. Instead, the LLC received DE treatment.

Partnerships Owning SMLLC's
An increasingly common arrangement for partnerships or multi-member LLC's is to own multiple subsidiary SMLLC's. For example, two real estate investors may form an LLC as a holding company for multiple sub-SMLLC's, in which each SMLLC holds title to one real estate investment. If properly structured and operated, each SMLLC should isolate the potential liability of each property.

> ***Example 7:*** *A* and *B* want to invest in three properties. Instead of just forming one LLC and placing all three properties in it, they form *AB* LLC (treated as a partnership because there are two owners); each of the three properties is placed in a separate SMLLC owned by *AB* LLC.

In Example 7, *AB* LLC owns three SMLLC's, but each SMLLC is a DE. Consequently, all the SMLLCs' income, gain, loss, expense, etc., are reported on *AB* LLC's Form 1065, U.S. Return of Partnership Income. Another benefit to this structure is that the two investors can agree to specially allocate items of income, gain, loss, depreciation, etc., of each SMLLC in a different manner (if so desired), as long as the allocations have substantial economic effect. Of course, one possible downside of this structure is dealing with the nontax issues of administering multiple entities (e.g., formation, bank accounts, recordkeeping, etc.).

Charitable Organizations

Joint Ventures

Charitable organizations sometimes enter into joint venture arrangements with for-profit partners. When this occurs, questions arise as to whether the charity's participation in the joint venture is in furtherance of its charitable purpose, whether income from the joint venture constitutes unrelated business income and whether the charity's involvement provides an impermissible private benefit for the for-profit partners. Despite these questions, however, a charity frequently chooses to participate in a joint venture through an SMLLC. The use of an SMLLC is beneficial, for example, when the charity would otherwise be acting directly as the general partner in an LP. By having the SMLLC be the general partner, the charity inserts a level of liability protection from the partnership's liabilities.

> ***Example 8:*** *M* organization, a public charity, enters into a joint venture with private investors to try to find a cure for a disease. The participants choose the LP form of doing business, with *M* acting as the general partner.

Under the facts of Example 8, instead of acting directly as the venture's general partner, *M* could create an SMLLC to serve as the general partner, thus providing liability protection and a separate level of management.

Charitable Contributions

Charitable organizations may form an SMLLC to isolate liability that may arise from property contributed to the charity. For example, if a charitable organization receives real property from a donor, it could also inherit some known or unknown liabilities. As a result, the charity may wish to have the donors contribute the property directly to an SMLLC it owns.

This raises the issue, however, of whether the donor can deduct the donation. The IRS has ruled that the assets held by an SMLLC owned by a charitable organization will be treated as owned by the charity and that the acceptance of a contribution of property to the LLC does not adversely affect the sole owner's exemption under Sec. 501(c)(3). The IRS has not directly ruled, however, on whether a donor's contribution directly to an SMLLC owned by a Sec. 501(c)(3) organization is deductible. Nevertheless, because the SMLLC is disregarded, the proper result clearly appears to be that the contribution should be deemed made to the charitable organization that owns the SMLLC.

Potential SMLLC Pitfalls

Although SMLLC's frequently offer tremendous business planning opportunities without negative Federal income tax consequences, taxpayers must still watch out for potential pitfalls when using them.

State and Local Taxes

Although many states "piggyback" onto the Federal income tax classification of LLCs, some have unique laws on LLC taxation. Texas and California, for example, impose certain taxes and fees on LLC's that many states do not. As with other business entities, LLC's are subject to taxes other than income taxes, such as property, sales and excise taxes. State income tax withholding

and unemployment tax issues should also be carefully evaluated so that an SMLLC is compliant with these areas, too.

SE Taxes

As discussed earlier, because an SMLLC is a DE, the business activity is considered to be a sole proprietorship; items of income, gain, loss, expense, etc., are reported directly on the individual owner's income tax return. For employment tax purposes, this means that an individual who is the SMLLC's sole owner is self-employed and subject to the self-employment (SE) tax regime. If the individual forms an S corporation, however, the shareholder can be an employee of the corporation. Consequently, the corporation can pay the shareholder-employee a "reasonable" salary (which would be subject to FICA taxes), but any excess profits from the S corporation would not be subject to FICA or SE taxes.

> ***Example 9:*** *O,* a sole proprietor, has the choice to operate her business through an SMLLC or an S corporation. The business will have operating net income of $70,000 for the year (before taking into account any amount paid to *O*). The entire $70,000 will be considered SE income if she operates the business through an SMLLC. However, if she operates the business through an S corporation and pays herself a salary of $50,000 (assuming this amount is reasonable), only the $50,000 is subject to FICA. The remaining $20,000 escapes employment taxes.

Caution: Despite this advantage of an S corporation, a tax adviser must be sure not to overlook the disadvantages of S corporation status, compared with an LLC, when advising a client which entity is the most appropriate.

International Taxation

Many tax practitioners forget that, although a domestic SMLLC is treated as a DE, a foreign LLC is treated by default as a foreign corporation under Regs. Sec. 301.7701- 3(b)(2) if no member has personal liability. To change from the default classification to DE status, the foreign LLC makes the election by filing Form 8832. If a foreign corporation conducts business in the U.S. via a domestic DE, the foreign corporation will be treated as directly operating in the U.S. as a branch of the foreign corporation, and the SMLLC would be disregarded. Depending on the facts and circumstances, an alternative may be to form a separate corporate subsidiary. Similarly, it may be more advantageous for a domestic corporation to operate in a foreign country via a foreign corporation, rather than through an SMLLC. For example, if a U.S. parent corporation owns a foreign corporate subsidiary, the U.S. parent does not recognize income for U.S. tax purposes on the foreign subsidiary's income until that income is repatriated. Taxpayers should also be aware of "hybrid entity" situations, in which the tax classification of an entity in a foreign country is different than in the U.S.

Asset Protection

Some tax advisers are concerned as to whether an SMLLC provides asset protection for the sole owner. This concern has no doubt been spurred on by *Albright,* in which a Federal bankruptcy court in Colorado held that a sole member's creditor could reach the SMLLC's assets through a charging order against his LLC interest. Specifically, the judge held that

> [a] charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member limited liability company because there are no other parties' interests affected.

The court further ruled that the bankruptcy trustee could sell the SMLLC's assets and distribute the proceeds to satisfy creditors' claims. This result has often been referred to as "reverse piercing."

Caution: This ruling related only to a charging order against the sole member's interest in the LLC, not to the general liability protection afforded the sole member from the SMLLC's "internal liabilities."

Conclusion

The CTB regulations have significantly simplified choice-of-entity decisions and added a greater sense of certainty for taxpayers. SMLLC's now play an important role in transactions covering a wide variety of practice areas, ranging from the fairly simple formation of an LLC for a sole proprietor, to the involvement of an SMLLC in sophisticated corporate reorganizations. One can only assume that the SMLLC will continue to flourish as the entity of choice in future business and tax planning.