WHEN-forming-a-new-business, ask yourself: Why not a limited liability company (“LLC”)? The question is not rhetorical. The LLC form is not always the best choice for a new business. An LLC is the right choice, however, in a majority of cases. Accordingly, an LLC should be the first form to consider for a new business.

Although state LLC statutes vary greatly, an LLC may now be formed under the laws of any state or the District of Columbia. Most (not all) multi-member LLCs are classified as partner-

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ships for federal income tax purposes under the Internal Revenue Code of 1986, as amended (the “Code”). See Treas. Reg. §§301.7701-1 to -4. Accordingly, except as otherwise stated, we will treat “LLCs” and “partnerships” as equivalent. Many of the advantages discussed in this article are advantages that LLCs have over S corporations, rather than over partnerships. The liberalization of the S corporation rules by the Jobs Creation Act of 2004 only slightly reduced the disadvantages of S corporations as compared to LLCs. The LLC will still be the preferred entity in most cases.

The tax differences between partnerships and multi-member LLCs are relatively minor compared to the differences between S corporations and multi-member LLCs. A multi-member LLC may differ from a state law partnership in various respects, such as the degree of liability protection, flexibility in governance, and waivability of fiduciary duties, as well as in aspects of state, local, federal, or foreign tax treatment. For purposes of this article, however, the differences between LLCs and state law partnerships will mostly be ignored.

This article is not intended as a comprehensive analysis of the pros and cons of various forms of entity. Our purpose, rather, is to encourage you to think first of the LLC. From that starting point, you may nevertheless find compelling reasons to choose another form of entity.

YOU CAN PAY ONE TAX INSTEAD OF TWO • An LLC is generally treated as a partnership for federal income tax purposes. Accordingly, the LLC itself is not subject to federal income tax, and all of its income, gain, loss, deduction, and credit are passed through to its members. §701 (All section references are to the Code unless otherwise indicated). Thus, operating a business through an LLC means one level of federal income tax, at the member-level.

By contrast, a C corporation is subject to an entity-level federal income tax on its income, and amounts distributed to shareholders are generally subject to an additional federal income tax at the shareholder level. §§11, 301. Accordingly, income earned by a C corporation and distributed to its shareholders is generally subject to two levels of taxation. S corporations are generally not subject to a corporate-level tax, except when the S corporation was formerly a C corporation, or when the S corporation acquired a C corporation in a tax-free transaction. See §§1374, 1375.

C corporations often attempt to “zero out” income by deducting salary, rent, interest, and other expenses. Depending on the circumstances, however, it can be difficult or impossible to “zero out” a C corporation’s income. A plan to “zero out” a C corporation’s income is especially prone to failure if the C corporation has assets that appreciate in value. Real estate is the classic example of an appreciating asset. But less obvious examples—including goodwill—can create massive tax liabilities. The limits of a strategy based on “zeroing out” income often become painfully apparent on a sale or other disposition of the business. Even a business formed as an S corporation can face difficult problems in these situations.

Example—Business Develops Goodwill

A and B form consulting firm X. X operates for several years without paying any corporate-level tax. X builds up valuable goodwill among customers. A and B then join Y LLC, a larger consulting firm, and take along the goodwill developed by X. A and B receive equity in Y LLC, but no upfront cash payment.

• If X is a C Corporation: Assuming that the goodwill is an asset of X, X is taxable as if it sold the goodwill at fair market value in a liquidating transaction. A and B are taxable as if X distributed the goodwill to them.
• If X is an S Corporation: In this case, X’s gain on the deemed sale of the goodwill is passed through to A and B who are taxable on such gain. In addition, A and B will be taxable on the deemed distribution to them, to the extent the distribution exceeds A’s and B’s tax bases in the S corporation stock. §1368(b).

• If X is an LLC: X has no taxable income, and in general neither does anyone else. The transaction should be characterized as a partnership merger under section 708(b)(2)(A) and Treas. Reg. §1.708-1(c).

In the foregoing example, X might have been able to avoid corporate-level tax on its operating income for a long period, but faced a day of reckoning when A and B tried to join another firm.

The example is biased in favor of the LLC form. If the acquirer is a corporation instead of an LLC, A and B might be able to receive acquirer stock in a tax-free corporate reorganization described in section 368(a)(1). Moreover, even if X is a corporation, and the acquirer an LLC, it may be possible to argue—in the right circumstances—that the goodwill is a personal asset of A and B (i.e., is owned by A and B individually, rather than by X), so that corporate gain is not triggered on a deemed disposition of the goodwill. See Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998).

The adverse impact of the double tax was reduced under legislation enacted in 2003. Most C corporation dividends to individual shareholders are taxable at long-term capital gain rates (normally, a maximum of 15 percent). The special tax rate on dividends, which is scheduled to last through 2008, reduces, but does not eliminate, the disadvantages of double tax. The adverse impact of double tax is also mitigated by the ability of C corporations to accumulate earnings without paying dividends. The ability to accumulate earnings is constrained, however, by the personal holding company tax and the accumulated earnings tax. §§531, 541.

YOU CAN CAPITALIZE IT ANY WAY YOU WANT • An LLC has nearly unlimited flexibility in the types of equity and debt interests that it may issue to its members. An LLC may issue all manner of common interests, preferred interests, vested or unvested interests, debt, and options to acquire any of the above. By comparison, an S corporation cannot have more than one class of stock, although differences in voting rights are permitted and an S corporation may issue multiple classes of debt. §1361(b)(1)(D). The “one class of stock” requirement for S corporations precludes the complex economic sharing arrangements among equity owners that business deals often demand, and that LLCs can accommodate. Moreover, creativity in structuring debt may be fatal to S corporation status, since in some circumstances a debt instrument or obligation may be treated as an impermissible second class of stock. Treas. Reg. §1.1361-1(l)(4)(ii). The operating rules of S corporation tax are simpler than those that apply to multi-member LLCs, but this simplicity is in large part a reflection of the inflexible requirements of S corporation capitalization.

Although a C corporation may have multiple classes of both debt and equity, the fact that a deduction is available for interest but not dividends tends to favor debt capital over equity capital, at least when the C corporation’s shareholders are not entitled to a dividends-received deduction. The tax advantage of debt may distort capitalization decisions for C corporations, creating higher debt to equity ratios than would otherwise make sense. Tax considerations influence financing decisions for an LLC as well, but often not to the same extent as for a C corporation.
YOU CAN PASS THROUGH LOSSES •
Losses incurred by a C corporation do not pass through to its shareholders. Accordingly, shareholders do not receive a direct tax benefit from a C corporation’s losses, as may shareholders in an S corporation or members in an LLC. Although the pass-through of losses of both LLCs and S corporations is limited by the bases of the owners (§§704(d), 1366(d)), the liabilities of an S corporation (unlike the liabilities of an LLC) are not included in the owners’ bases. The exclusion of entity-level liabilities from the basis of S corporation shareholders reduces the amount of losses that can flow through to the shareholders. (As explained below in connection with distributions, this basis rule also tends to make the distribution of financing proceeds taxable to the shareholders.) Nevertheless, despite the inclusion of LLC debt in the bases of the LLC members (§752), there are numerous restrictions on the deduction of losses that are passed through from an LLC. See, e.g., §§465, 469 and 704(d).

ANYONE CAN OWN AN LLC • Any type of person—whether an individual or an entity—may be a member of an LLC. This is not necessarily to say that LLCs may engage in any type of business, although there are relatively few limits. State law or professional ethics requirements sometimes prevent professionals (e.g., doctors, attorneys or accountants) from operating in LLC form. Conversely, certain states have specifically limited membership in limited liability partnerships to licensed professionals in the same discipline.

An S corporation imposes the tightest restrictions on membership—it cannot have as a shareholder a person who is a nonresident alien, or a person other than an individual, an estate, or one of certain types of trusts or tax-exempt corporations specified in the Code. §§1361(b)(1)(A), (B) and (C); 1361(c)(2) and (6). In principle, just one ineligible shareholder of an S corporation, such as a partnership or a corporation, will cause the S corporation status to terminate. The restrictions on S corporation membership arise under the tax rules rather than under state business entity principles. “S corporation” is strictly a tax concept. An S corporation need not even be a “corporation” under state law. See Treas. Reg. §301.7701-3T(c)-(1)(v)(C); Pvt. Letter Rul. 200450012 (Aug. 26, 2004).

There is no minimum or maximum number of LLC members. Entities formed as partnerships under state law, however, require at least two members. S corporations cannot have more than 100 shareholders, although all members of a “family” can be treated as one shareholder. §1361(b)(1)(A). This limit on the number of S corporation shareholders, effective for tax years beginning after December 31, 2004, is a liberalization of the prior rule. Before the American Jobs Creation Act of 2004, the upper limit on S corporation shareholders was 75, and only a husband and wife could be treated as one shareholder. (The 2004 Act eased several other S corporation rules, but the changes were generally minor. These changes perhaps have the greatest impact on community banks. Banks cannot be classified as partnerships for tax purposes, and so for them the potential advantages of partnerships over S corporations are irrelevant. To achieve pass-through tax treatment, a bank must qualify as an S corporation.)

Although anyone may own an interest in an LLC, there are some practical limitations. For example, if ownership of the interest would cause an LLC to be classified as a publicly traded partnership for federal income tax purposes, the LLC may be taxed as a corporation. §7704(a). In general, an LLC will be treated as a publicly traded partnership if interests in the LLC are traded on an established securities
market, or are readily tradable on a secondary market or the equivalent. However, interests in an LLC will generally not be treated as readily tradable on a secondary market if the LLC does not have more than 100 members at any time during a particular tax year. Treas. Reg. §1.7704-1(h)(1)(ii). In addition, pass-through of income to members of an LLC may be unattractive to some investors, such as certain foreign persons or tax-exempt entities. Most individuals (other than lawyers and accountants) also generally prefer to be treated as “employees” rather than as “partners” for tax purposes. (One reason for preferring “employee” status, as discussed briefly below, is the avoidance of self-employment tax.)

**YOU CAN EASILY MAKE TAX-FREE CONTRIBUTIONS** • In general, neither the LLC nor any of its members will be required to recognize any gain on the transfer of property to an LLC in exchange for an interest in the LLC. §721(a). However, contributions of property to C corporations or S corporations by their shareholders only qualify for tax-free treatment if the transferring shareholders control the corporation immediately after the transfer. §351(a). For this purpose, “control” is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. §368(c).

**Example—Contribution By Minority Owner**

A and B contribute property to newly formed X. Some time after X has been formed, C comes along, and contributes appreciated property with a basis of zero and fair market value of $100,000 to X in exchange for 20 percent of the equity of X.

- **If X is a C Corporation or S Corporation:** C will have $100,000 of taxable gain because C is not in control of X immediately after the exchange, and is not part of a control group with A and B.
- **If X is an LLC:** C has no taxable gain. There is no 80 percent control requirement for LLCs.

If the property transferred to a corporation is subject to a liability, then, even if the transfer would otherwise be tax-free because the transferring shareholders meet the control requirement, the transferor will generally be required to recognize gain equal to the excess of the amount of the liability over the transferor’s basis in the property transferred. §357(c). By contrast, if a member of an LLC transfers encumbered property to the LLC, the member is generally not required to recognize any gain if a sufficiently large portion of the debt is allocated to the member under section 752.

**Example: Liability In Excess Of Basis**

A and B form X. A contributes $200,000 in cash to X in exchange for a 50 percent interest in X. In exchange for the other 50 percent interest in X, B contributes property to X with basis of $500,000, and fair market value of $1 million, but subject to an “old and cold” liability of $800,000. X assumes the liability and each of A and B guarantees 50 percent of the liability.

- **If X is a C Corporation or S Corporation:** B will recognize gain of $300,000 (the excess of the amount of the $800,000 liability over B’s $500,000 basis).
- **If X is an LLC:** B would generally recognize no taxable gain. However, because B is relieved of half of the $800,000 liability, B is treated as receiving a $400,000 cash distribution from X, which reduces his basis in his interest in X from $500,000 to $100,000. See §§705(a), 722, 752.

However, even when X is an LLC, transferring property—especially encumbered property—can be tricky. Besides the debt allocation rules, the possible application of the disguised
sales provisions should be taken into account when making a choice of entity decision (§707-(a)(2)(B) and Treas. Reg. §§1.707-3 to -9).

YOU DON’T PAY TAX ON THE OTHER OWNER’S BUILT-IN GAIN • In general, if a member of an LLC contributes property with a built-in gain or loss to an LLC, the built-in gain or loss is specially allocated to the contributing member upon a later taxable disposition of the property by the LLC. §704(c). C corporations and S corporation have no corresponding principle. Thus, a shareholder of a corporation may be required to bear the tax burden of built-in gain property transferred to the corporation by another shareholder.

Example—Tax On Built-In Gains
A and B form X. Each has an equal interest. A contributes property with a fair market value of $1 million and a basis of zero. All $1 million is depreciation recapture. B contributes property with a fair market value of $1 million and a basis of $1 million. Shortly afterwards, X sells the property contributed by A for $1 million.

- If X is a C Corporation: Neither A nor B has taxable income on the contribution. X has $1 million of ordinary income on the sale of the property contributed by A. B suffers a decline in value in his share of X’s stock because of the tax payment, but B never enjoyed the gain on which the tax is paid.
- If X is an S Corporation: Neither A nor B has taxable income on the contribution. Each of them has $500,000 of ordinary income on the sale of the property contributed by A. Economically B has no gain; B is paying tax on $500,000 of A’s economic gain.
- If X is an LLC: Neither A nor B has taxable income on the contribution. A has $1 million of ordinary income on the sale of the property contributed by A; B has no income. §704(c). A pays tax on his own gain.

The distortion caused by the S corporation form in this example, however, could be an advantage if the parties actually wanted B to bear A’s tax liability (although in that case the IRS might invoke anti-abuse principles in an effort to prevent the distortion).

YOU CAN GET TAX-FREE EQUITY FOR SERVICES • In most instances, if a person provides services to an LLC in exchange for a vested or nonvested “profits interest” in the LLC, neither the LLC nor the service provider is taxable on the exchange or, in the case of a nonvested interest, on the vesting date. Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191. The IRS may attempt to tax the receipt of a profits interest, however, if the profits interest relates to a substantially certain and predictable stream of income from the LLC’s assets, if the service provider disposes of the profits interest within two years of receipt, or if the LLC is a publicly traded partnership.

On the other hand, if a person provides services in exchange for a “capital interest” in the LLC, this exchange is generally a taxable event. Treas. Reg. §1.721-1(b)(1). A capital interest is defined for this purpose as any interest that would give the holder a share of the proceeds if the LLC’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the LLC. A profits interest is any interest in the LLC other than a capital interest. Rev. Proc. 93-27, 1993-2 C.B. 343.

By contrast, if a person provides services (either past or future) to a corporation in exchange for stock in the corporation, the receipt of stock will generally be taxable to the service provider. Treas. Reg. §1.351-1(a)(1)(i). In addition, if multiple parties transfer property and provide services to a corporation in exchange for stock, the issuance of stock to the service providers may cause the shareholders transferring property not to have the requisite control
of the transferee corporation immediately after the exchange. In that case, the entire exchange (i.e., both to the service providers and the property transferors) may become taxable.

Example—Equity For Property And Services

A and B form X. A contributes property to X, with a basis of zero and a fair market value of $1 million, in exchange for a 50 percent interest in X. B contributes future services that he will perform for X, and he receives an unrestricted 50 percent interest in X.

- **If X is a C Corporation or S Corporation:** A will have taxable gain equal to $1 million because he is not in control of X immediately after the exchange, and is not part of a control group. B will have taxable ordinary income equal to $500,000 (or whatever other amount B’s interest in X is valued at). However, X should have a deduction for the compensation paid to B.
  - **If X is an LLC:** A has no taxable gain. B will also have no taxable gain, provided he receives only a profits interest in X.

**YOU CAN TAKE TAX-FREE DISTRIBUTIONS**

- Distributions of cash or property made by an LLC to its members are never taxable to the LLC. §731(b). (We stress again that, unless stated otherwise, we are treating “LLC” and “partnership” as synonyms. An LLC classified as a corporation for tax purposes of course faces vastly different consequences.) In addition, such distributions are usually not taxable to the LLC’s members, because the LLC members are taxable as the LLC earns income, whether or not the income is actually distributed. §§731(a), 702. There are exceptions for certain distributions of cash, marketable securities, property previously contributed to the LLC with a built-in gain, and distributions that cause a member’s share of the LLC’s liabilities to decrease. See §§731(a), 731(c), 704(c), 737, 752(b).

Moreover, not every amount a member receives from an LLC is a “distribution.” For example, a member may receive interest on loans to the LLC, or the proceeds of the sale of property to the LLC, or guaranteed payments for services or capital provided to the LLC. §707(c).

The distributee member generally takes a transferred basis in the distributed property, and must reduce his outside basis by any cash received plus the basis taken in the distributed property. §§732(a), 733. In a liquidating distribution, the distributee will not have an outside basis after the distribution. Accordingly, the distributee’s basis in the property distributed is determined not by reference to the partnership’s inside basis for those assets, but by reference to the distributee’s outside basis (as reduced by any cash distributed). §§732(b).

By contrast, a corporation generally recognizes taxable gain when it distributes appreciated assets to shareholders. §§311(b), 336. In the case of a C corporation, the corporation itself is taxable on the gain. In the case of an S corporation, the gain generally passes through to the shareholders and is taxable to them. The amount of the gain is calculated as if the property distributed was sold for its fair market value.

The shareholders of a C corporation generally recognize taxable income when they receive distributions. §§301, 302, 331(a). Like a member of an LLC, however, an S corporation shareholder is generally only taxable on distributions to the extent the distributions exceed the shareholder’s tax basis in his S corporation stock. §1368(b). However, if the S corporation was formerly a C corporation (or acquired a C corporation in a tax-free transaction), distributions may be subject to tax to the extent of the S corporation’s accumulated earnings and profits (after the S corporation’s “accumulated adjustments account” has been reduced to zero). §1368(c).
Example—Distribution Of Property

A and B are equal owners of X. Each of A and B has a basis of $100,000 in his interest in X. X owns real property with a fair market value of $1 million and a zero tax basis, and also has $1 million in cash. X distributes the cash to A and the real property to B.

- **If X is a C Corporation:** Each of A and B has $900,000 of taxable gain. In addition X itself also has $1 million of taxable gain. (X presumably would have to reduce the amount of distributions made to A and B so that it could pay its tax.)

- **If X is an S Corporation:** Each of A and B has $900,000 of taxable gain, which consists of (i) his $500,000 share of the $1 million gain recognized by X when X disposes of the property (under section 336 for liquidating distributions or section 311 for non-liquidating distributions), which $500,000 gain increases each of their bases from $100,000 to $600,000, and (ii) an additional $400,000 of gain (§1 million less $600,000 basis) on the $1 million distribution to each (whether in cash or in property). See §1367.

- **If X is an LLC:** There is no gain to X. B has no taxable gain because he receives no cash or marketable securities. However, A still has $900,000 of taxable gain. See §731(a).

Furthermore, to the extent that an LLC incurs debt, the LLC members’ basis in their membership interests will be increased by their share of the debt incurred. §752(a). However, the liabilities of an S corporation are not included in its shareholders’ basis. §§1366-(d)(1), 1367(b)(2). Accordingly, a debt-financed distribution by a corporation may be taxable, when it would be tax-free if made by an LLC.

Example—Debt-Financed Distribution

A and B form X, A contributes $1 million in cash to X in exchange for a 50 percent interest in X, and B contributes property to X with a zero basis and a fair market value of $1 million in exchange for a 50 percent interest in X. X borrows $500,000 on a nonrecourse basis from an unrelated lender. Although X has zero net income, X makes a distribution of $100,000 to each of A and B.

- **If X is a C Corporation or S Corporation:** A can receive the distribution tax-free, although it reduces A’s basis in X from $1 million to $900,000. B, however, has taxable gain on the $100,000 distribution because he has a zero basis in his interest in X.

- **If X is an LLC:** Neither A nor B is taxable on the distribution. A’s basis would decrease from $1.25 million (i.e., A’s $1 million basis from the cash contribution plus A’s share of the $500,000 debt) to $1.15 million and B’s basis would decrease from $250,000 (i.e., B’s share of the $500,000 debt) to $150,000.

YOU CAN “STEP UP” YOUR SHARE OF INSIDE BASIS • The buyer of an interest in an LLC takes a cost basis in that interest. The buyer inherits the seller’s capital accounts and the seller’s share of inside basis. In almost all cases, this will result in a disparity between the buyer’s outside basis and his new share of inside basis unless the LLC makes (or has previously made) an election under section 754. If this election is made, the new member is entitled to a special basis adjustment that is intended to eliminate this disparity. §§743(b), 754, 755. A buyer of an interest in an S corporation, however, has no comparable means of eliminating such a disparity.

The seller of an interest in an LLC generally recognizes gain or loss on the sale of the interest equal to the difference between the amount realized and the seller’s outside basis. §741. The character of that gain will be capital except to the extent that it is attributable to certain ordinary income assets. §751. By contrast, the seller of an interest in an S corporation (or C
corporation) generally recognizes capital gain on the sale of that interest, despite the presence of ordinary assets in the corporation. (A notable exception is where the buyer and seller agree to, and are eligible for, an election under section 338(h)(10), which causes a stock sale to be treated more like an asset sale.) Although the added potential for capital gains is a benefit of S corporation status, this benefit needs to be weighed against other problems, including the inability to step up inside basis within an S corporation.

Example—Gain On Sale Of An Interest

A and B are equal owners of X. They have held their interests longer than one year, and have zero tax bases. X owns depreciated equipment, which originally cost $1 million. The equipment still has a fair market value of $1 million, but a zero tax basis. B sells his interest in X to C for $500,000.

- If X is a C Corporation or S Corporation: B has capital gain. The maximum federal capital gain rate for individuals is 15 percent. B’s federal tax is $75,000.

- If X is a C Corporation or S Corporation: B has capital gain. The maximum federal capital gain rate for individuals is 15 percent. B’s federal tax is $75,000.

- If X is an LLC: B has ordinary income because the value of his interest is attributable to “depreciation recapture” property. The maximum federal ordinary income rate for individuals is generally 35 percent in 2005. B’s maximum federal tax is $175,000, more than twice as much as the tax if X is an S corporation.

Example Continued—Subsequent Gain On Sale Of Assets

In the same example, one week after C buys its interest for $500,000, X sells its zero-basis equipment for $1 million.

- If X is a C Corporation: X has $1 million of taxable income, all of which is ordinary income. Assuming the maximum corporate tax rate (in 2005) of 35 percent applies, X will pay $350,000 of tax. C suffers a decline in value in his share of X’s stock because of the tax payment, but C never enjoyed the gain on which the tax is paid.

- If X is an S Corporation: C has $500,000 of taxable income (50 percent of total), all of which is ordinary income. Economically, however, C has enjoyed no income or gain. C paid $500,000 for his interest and his interest is still worth just $500,000. If C understands the problem, C will be much less likely to pay $500,000 for his interest in the first place.

- If X is an LLC: If X makes an election under section 754 to adjust basis, C has no taxable gain. See §743(b).

YOU CAN CHANGE YOUR MIND LATER

- In general, converting from an LLC to a corporation is not a taxable event. See Rev. Rul. 84-111, 1984-2 C.B. 88. Such a conversion is normally treated as a contribution of the LLC’s assets to a newly formed corporation in exchange for its stock, followed immediately thereafter by a distribution of the stock to the LLC’s members in liquidation. Accordingly, care must be taken in such a conversion to ensure that the former LLC’s members have control of the newly formed corporation immediately after the conversion. §§351(a), 368(c).

By contrast, converting from a C corporation to an LLC is generally taxable to both the corporation and its shareholders. The conversion is generally treated as a liquidation of the corporation, taxable under sections 331 and 336, followed by a nontaxable contribution of assets by the former shareholders to the newly formed LLC under section 721. If the conversion is of a corporate subsidiary, the deemed liquidation may be tax-free under sections 332 and 337. The conversion of an S corporation to an LLC normally triggers at least one level of tax. §336.
LLCS CAN BE “TAX NOTHINGS” • A single-member LLC generally can be disregarded as an entity separate from its member for federal income tax purposes—a “tax nothing,” equivalent to an unincorporated branch or division. See Treas. Reg. §301.7701-3. An LLC classified as a tax nothing is one of the exceptions to the rule that LLCs and partnerships are equivalent for tax purposes, since a tax nothing is not a partnership.

Single-member LLCs—permitted now under almost all LLC statutes—are commonly used to insulate assets from liabilities, without any federal tax consequences. For example, a “contribution” to a tax nothing is essentially ignored for tax purposes as is a “distribution” from a tax nothing, so there is no transaction, and no gain (or loss) realized. No state permits a single-member partnership, and it is more cumbersome to structure state law partnerships as tax nothings. A state law corporation almost always must be recognized as a separate entity for tax purposes.

THE U.S. FEDERAL GOVERNMENT IS NOT THE ONLY TAXING JURISDICTION • Despite the treatment of an LLC as a partnership or disregarded entity for United States federal tax purposes, an LLC will sometimes be treated as a separate entity for state or local, or foreign, tax purposes. Although most states classify LLCs for state income tax purposes consistently with their federal tax treatment, certain states, such as Texas, treat LLCs (single-member or multi-member) as corporations for income tax purposes. Tex. Tax Code §§171.001-(a), 171.110(d) (2004). Other states, such as Montana, do not permit a single-member LLC to be disregarded as separate from its owner for state income tax purposes, and treat such an LLC instead as a corporation. See Mont. Admin. R. §42.23.702 (2004).

Furthermore, states often treat single-member LLCs as separate entities for purposes of taxes other than income tax, such as sales/use tax and real property transfer tax. These differences can generate planning opportunities as well as pitfalls.

Example—Pitfall
If A transfers real property to its wholly owned LLC, then A may be subject to real estate transfer taxes on the transfer, even though the transaction will have essentially no federal or state income tax consequences. This pitfall, however, may turn into an opportunity. All subsequent transfers of the LLC interest may be excluded from real estate transfer tax, depending on state law, since an LLC interest is personal property, whereas multiple transfers of the real property normally would trigger multiple transfer taxes.

Example—Planning Opportunity
Suppose X is formed in State 1, operates a store in State 2, and sells items to A in State 2 through X’s Internet business. X is generally required to collect use tax on the sale to A, because X has nexus with State 2 through its store in State 2. However, if X forms a wholly owned LLC in State 1 (which is treated as a separate entity for sales/use tax purposes) to operate X’s Internet business, then the LLC may not have to collect use tax on the sale to A, because the LLC does not have nexus with State 2, even though the LLC is disregarded for income tax purposes. Some states may attempt, however, to attribute X’s sales tax nexus with State 2 to the LLC.

Similarly, an LLC that is treated as a partnership or a disregarded entity for U.S. federal tax purposes may be treated as a corporation for foreign income tax purposes.

Even states that do treat LLCs as partnerships or disregarded entities for income tax
purposes may impose taxes or fees on LLCs. For example, California currently imposes an annual fee of up to $11,790 on the California-source “total income” of an LLC (generally, its gross income plus the cost of goods sold in connection with the LLC’s business). Cal. Rev. & Tax. Code §17942(a) (2005). In addition to this annual fee, California imposes an $800 annual minimum tax on all LLCs and partnerships doing business (or qualified to do business) in California. Cal. Rev. & Tax. Code §§17941(a) and (b)(1) (2005). By comparison, California imposes a 1.5 percent tax on the net income of S corporations doing business in the state, subject to an $800 minimum tax. Cal. Rev. & Tax. Code §§23802(a) and (b)(1) (2005).

SELF-EMPLOYMENT TAX AND OTHER POSSIBLE DISADVANTAGES • Although this article tries to explain why an LLC should be the first form of entity to think of when forming a new business, choosing the right form of entity can be a complicated task and there is no universally correct solution. One concern, as discussed above, is that the LLC may be operating in a jurisdiction (either state or foreign) that treats LLCs unfavorably, either for income tax purposes or for some other tax purpose (e.g., sales/use, real estate transfer tax, etc.).

In addition, LLCs are not eligible for certain tax benefits available under the Code to other types of entities. Notably, as suggested above, corporations may engage in tax-free “reorganizations” (including certain mergers and acquisitions) as defined in section 368(a)(1). LLCs do not have this option. In a tax-free corporate reorganization, stockholders of the target may be entitled to dispose of their shares, without gain recognition, and receive stock of the acquirer—a genuine advantage of corporate status in some instances. The greater ability of LLCs, however, to engage in tax-free contributions and distributions may facilitate tax-free transactions that would be impossible between corporations. Moreover, as discussed above, LLCs often find it easy to convert to corporations tax-free, although a conversion on the eve of a corporate reorganization can be risky.

For many owner-operated businesses, self-employment taxes loom large despite the relatively low rates that apply to income above $90,000 (for 2005). Individual LLC members are often subject to self-employment tax on their shares of the LLC’s business income. Some advisers recommend S corporations over LLCs as a way of avoiding self-employment tax, and reducing overall employment taxes. Although the possible advantages of the S corporation should be taken seriously, the contrast between LLCs and S corporation is not as stark as is sometimes presented.

The owner/employees of an S corporation are not subject to self-employment tax, but their salary is subject to employment tax (FICA). An S corporation that reduces employment tax by underpaying owner/employees may find the IRS attempting to recharacterize dividends as compensation.

LLC members cannot reduce their self-employment tax liability by substituting dividends for compensation. Many LLCs attempt to reduce self-employment tax, however, by relying on the rule that “limited partners” are only subject to self-employment tax on “guaranteed” payments for services. See §1402(a)(13). The IRS years ago proposed regulations that would have characterized some—but far from all—LLC members as “limited partners.” Prop. Treas. Reg. §1.1402(a)-2(h) (1997), replacing a 1994 set of proposed regulations. Because of the extraordinary controversy the proposed regulations stirred up, however, it is unlikely that the IRS will finalize any regulations until Congress signals its position.

In the absence of authoritative guidance, LLC members have adopted widely divergent practices in complying with their self-employment tax obligations. The most conservative position is that an LLC member is simply not
a “limited partner” under the federal self-employment tax, since an LLC member is not a “limited partner” under state law. Other LLC members are far more aggressive, arguing that all LLC members come within the meaning of “limited partner” for purposes of section 1402-(a)(13), even if they are not technically “limited partners” under state law. Many take a middle position, often, but not always, based on the 1997 proposed regulations.

AN LLC IS MORE OFTEN THAN NOT THE RIGHT CHOICE, BUT IS IT RIGHT FOR YOU? • Overall, the LLC form offers many tax advantages, besides flexibility and limited liability. There are circumstances in which an LLC may not be the preferred choice, but the LLC generally ought to be the first form of entity that comes to mind for a new business.

PRACTICE CHECKLIST FOR
Why Not Form A New Business As An LLC?

In forming a new business, ask yourself: Why not an LLC? The question is not rhetorical. The LLC form is not always the best choice for a new business. An LLC is the right choice, however, in a majority of cases. Accordingly, an LLC should be the first form to consider for a new business. Why?

Subject to some limitations, including the ones discussed in this article:

__ You can pay one tax instead of two, thanks to pass-through taxation.
__ You can capitalize the LLC any way you want.
__ You can pass through losses.
__ Anyone can be an owner.
__ You can make tax-free contributions easily.
__ You don’t pay tax on the other owner’s built-in gain.
__ You can get tax-free equity for services.
__ You can make tax-free distributions.
__ You can “step up” your share of inside basis.
__ You can change your mind later.
__ Single-member LLCs can be “tax nothings.”