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LLC Electing to be Taxed as a Subchapter S Corporation*

For those intending to form a closely held operating business in Florida, the entity of choice, in most cases, will be a limited liability company that elects to be taxed as a Subchapter S corporation. We refer to this entity as the LLC envelope.

Following the issuance of "check-the-box" regulations in 1997, eligible entities (1) (including eligible LLCs) have been able to select their classification for federal tax purposes under an elective regime. Eligible entities, such as the LLC envelope, may elect to be taxed as a corporation, an S corporation, a partnership, or, in the case of single-member LLCs, a disregarded entity. As a result, since 1997 practitioners have been able to select the best combination of state law attributes and federal tax treatment to achieve an entity structure suited to the particular needs of a business. This flexibility changes the entity selection process from one driven first by considerations of federal tax law to one driven first by considerations of state law. Reversing the traditional analysis sequence provides greater entity design flexibility. However, few practitioners appear to have recognized this advantage. (2)

The LLC envelope constitutes a hybrid structure that marries the benefits of an LLC (a function of state law) with those of an S corporation (a function of federal tax law). This marriage achieves three principal benefits: 1) protection of the owners' interests in the company from their personal liabilities ("asset protection"); 2) protection of the assets of the owners from the liabilities of the enterprise ("limited liability"); and 3) the lowest federal employment tax (3) liability for owners employed by the business. The LLC envelope is the only Florida entity that provides all three of these benefits.

While providing the above-out-lined benefits, the LLC envelope also avoids a new and serious problem faced by many C corporations (particularly professional and other personal service corporations) as a result of the recent case Pediatric Surgical Assoc., P.C. v. Comm'r, T.C. Memo. 2001-81. Pediatric held that profits derived from associate physicians in a medical practice were corporate profits and could only be distributed to shareholder physicians of the C corporation as dividends, thus imposing two layers of tax on the profits generated by the associates.

This article will discuss the asset protection, limited liability, and federal tax benefits of the LLC envelope, analyze those situations where the LLC envelope would not be a good choice, and outline certain material considerations which impact the process and decision to convert an existing entity into an LLC envelope.

Asset Protection Benefits

The LLC is a creature of state law, and, as a result, its benefits derive from Florida statutory authority. (4) Among the most material of those benefits is the protection provided by F.S. [section] 608.433(4), which safeguards the membership interest of an LLC owner from loss by limiting a creditor to the remedy of a "charging order." While a charging order provides a creditor with the rights of an assignee, which entitles a creditor to receive distributions to which the debtor-owner would otherwise have been entitled, the debtor-owner will continue to own its membership interest in the LLC and, otherwise, operate its business without interference from the creditor. The creditor cannot vote on business matters, inspect or copy business records, nor exercise any of the debtor-owner's rights with respect to the management of the business. Conversely, the owners of a corporation (both S and C) have no similar benefit, as their creditors are not limited in their remedies to a charging order. As a result, shares of stock are subject to levy and loss to shareholder-creditors, who may thereafter exercise control over the business to the same extent as was exercised by the debtor-shareholder, including the right to manage or liquidate the business. Accordingly, the Florida LLC provides a distinct measure of "asset protection," while the Florida corporation provides none.

Some commentators believe that, in addition to constituting a nominal remedy, the charging order may actually be a detriment to its holder. They argue that a creditor who utilizes a charging order to obtain the rights of an assignee is treated as a partner for federal income tax purposes. (5) While these commentators only address assignees of "partnership interests," the same logic ought to be applicable to creditors utilizing a charging order to obtain the rights of an assignee of a member of an LLC taxed as an S corporation, since an S corporation is also a flow-through entity. (6) As a result, if an LLC taxed as an S corporation earns income, which is allocated but not distributed to the owners, the creditor with the charging order may recognize phantom income. No similar detriment exists for the creditor of a shareholder.

Thus, the charging order limitation mandated by state law may provide the advantage of both asset protection for the debtor-owner and potentially unfavorable tax treatment for the creditor. This combination of state law benefits (which limit a creditor's remedies to a charging order) and federal tax law detriments (which may subject the holder of a charging order to phantom income) arm the LLC owner-debtor with an advantage over his or her creditors, thereby potentially enabling the LLC owner-debtor to settle disputes with them more favorably.

It should be noted, however, that clients who desire these asset protection benefits should be encouraged to form an LLC with at least two members. In In Re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003), the bankruptcy court, interpreting a Colorado charging order statute that is similar to Florida's statute, held that a creditor of a member of a single member LLC was not limited to the charging order remedy. The court reasoned that the charging order limitation was intended to protect the investment of each member from the creditors of every other member, and that no such protection was necessary for a single member LLC.

Limited Liability Benefits

Of the limited liability entities in Florida offering both asset protection and limited liability, LLCs offer the most secure limited liability shield--a shield equivalent to that of a corporation. F.S. [section] 608.701 provides that in any case in which a party seeks to pierce the veil of an LLC, the court must apply the same case law as would apply to the piercing of a corporate veil under similar circumstances. As a result of the Florida Supreme Court case Dania Jai-Alai Palace, Inc. v. Sykes, 450 So. 2d 1114 (Fla. 1984), which held that a corporate veil could not be pierced without a showing of fraud or an improper purpose, the limited liability shield of a Florida corporation is among the most difficult to pierce in the United States. Mere disregard of corporate formalities, inadequate capitalization, informal loan transactions, and similar poor practices will not justify piercing the corporate veil in Florida. (7)

On the other hand, F.S. [section] 620.8306, which applies to both limited liability partnerships and limited liability limited partnerships, merely provides that a partner shall not be personally liable for the obligations of the partnership "solely by reason of being or so acting as a partner." The legislature's failure to explicitly integrate the corporate standard set forth in Dania Jai-Alai Palace creates uncertainty as to whether some lesser standard could be applied to pierce the limited liability shield of LLPs and LLLPs.

Additionally, while Florida law provides partners of LLPs and LLLPs with limited liability, (8) it also allows for the loss of limited liability in instances of mere inadvertent oversight. This occurs when the secretary of state revokes the statement of qualification for failure to file an annual report and the partnership fails to apply for reinstatement within two years. (9) Conversely, an LLC is not subject to loss of limited liability as a result of an inadvertent administrative failure. (10)

Federal Tax Benefits

Why should a closely held operating business formed as a Florida LLC elect taxation as an S corporation? Taxation as an S corporation offers two principal advantages. First, the Internal Revenue Code of 1986, as amended, provides that the profits and losses of an S corporation flow through to the owners in a manner similar to a partnership, thus avoiding double taxation. Second, employee-owners may be able to reduce federal employment taxes by as much as 15.3 percent on the portion of their income equal to or below $87,000 per year, (11) and 2.9 percent on income in excess of $87,000. This tax strategy, which is a function of reducing wages and increasing distributions, is only available to entities taxed as S corporations.

Partners (other than limited partners) and owners of disregarded entities may not bifurcate their income between wages and distributions to reduce their self-employment tax, as all their income is subject to the tax, whether the

income is received as distributive share, salary, or payment as an independent contractor. (12)

The following is a simple example illustrating how an employee-owner of an operating business can benefit from the utilization of the wage-reduction tax strategy. Assume each employee-owner of an S corporation earns an annual income of $125,000 from the business. Assume further that those employee-owners agree to set their salaries at $67,000 and distribute the remainder (i.e., $58,000) as distributions. By separating the earnings into salary and distributions, each employee-owner will save 15.3 percent of $20,000 (the difference between $67,000 and $87,000), or approximately $3,600. Each employee-owner will also save 2.9 percent of $38,000 (the difference between $87,000 and $125,000), or approximately $1,100, for a total savings of $4,700 per year. Obviously, the lower the employee-owners set their salaries the greater the tax savings; however, salaries must be reasonable, with reasonableness determined on the basis of the facts and circumstances of each situation.

In light of Pediatric, it is important to address those professional and other personal service businesses operating as C corporations, which have assumed that they could successfully avoid double taxation by utilizing the strategy of "bonusing" sufficient amounts of compensation to shareholder-employees until the corporation's income is reduced to zero. Until now, this strategy enabled the personal service C corporation to avoid double taxation. Pediatric, however, has rendered this strategy unsound for many personal service corporations. (13)

Finally, until 2003, C corporations enjoyed an advantage over S corporations, since C corporations were the only federal income tax regime where the health insurance costs of owner-employees were fully deductible. Pursuant to Code [section] 162(1), beginning in 2003, regardless of the taxing regime chosen, all self-employed individuals can deduct 100 percent of the amount paid for accident and health insurance premiums. (14)

When an LLC Envelope Should Not Be Used

While an LLC envelope offers substantial advantages over other entities, there are at least five common circumstances when a tax regime other than an S corporation may be more appropriate: 1) the business cannot qualify as an S corporation; 2) the one-class-of-stock limitation for S corporations cannot accommodate certain business terms agreed to by the parties; 3) the business involves appreciating assets (i.e., assets that have, or are likely to have, a fair market value in excess of basis), such as real estate; 4) the business has considerable debt and the owners anticipate significant losses; (15) and 5) the wage-reduction tax strategy explained previously will not benefit the owners because either the primary income of the business is excluded from self-employment tax (16) or, in the case of newly formed companies, one or more employee-owners already receive aggregate wages or self-employment income from an existing business in an amount which approaches the taxable wage base limitation ($87,000 for 2003). (17)

To qualify as an S corporation, the business must fit the Code [section] 1361(b) definition of a "small business corporation," which means a domestic corporation that is not an "ineligible corporation" (as identified in Code [section] 1361(b)(2)) and that does not have: 1) more than 75 shareholders; 2) a shareholder who is a nonresident alien; 3) a shareholder who is not an individual, an estate, a permitted trust or a permitted exempt organization; or 4) more than one class of stock.

The one-class-of-stock rule requires that all stock have identical rights to distribution and liquidation proceeds, but allows differences in voting rights and management control among shareholders. When a business cannot elect to be an S corporation, the one-class-of-stock rule is typically the culprit. The one-class-of-stock rule creates several significant limitations, the most detrimental of which include the elimination of the ability to: create preferred returns for investors; (18) create and grant noncapital interests in the business (making it easier to admit new employee-owners to the business) which are not subject to immediate tax recognition because the interest is limited to the future profits of the business; (19) and fractionalize ownership interests (other than for voting control) which serve as the basis for valuation discounts used for estate and gift tax planning. In comparison, the partnership tax form can overcome all of these limitations.

Owners who intend to acquire appreciating assets for their business, such as real estate, may want to avoid S corporation taxation for two principal reasons: Appreciated property cannot be distributed by the S corporation to its shareholders without the recognition of gain; (20) and money borrowed by an S corporation will not increase a shareholder's basis in his or her stock. (21) These two limitations result in several adverse ramifications which, like the ramifications of the one-class-of-stock rule, may not be immediately apparent to counsel, such as the possible recognition of gain in the following instances: (i) conversion to a partnership; (22) (ii) exit from a real estate investment (because each shareholder cannot enter into a separate Code [section] 1031 like-kind exchange); (23) or distribution of S corporation loan proceeds to shareholders. (24)

Conversion To An LLC Envelope

Because of the above-described advantages, many businesses should consider converting to an LLC envelope. In particular, C corporations operating as professional and other personal service businesses (such as attorneys, physicians, and accountants), should evaluate their exposure to Pediatric and consider conversion to an LLC envelope.

The conversion of an existing entity into an LLC envelope involves consideration of both state law issues, which are mostly administrative, and federal tax law issues, which are more complex and frequently require careful planning to minimize or avoid adverse tax consequences. For state law purposes, corporations (whether C or S) must merge into a newly formed LLC envelope, while partnerships can simply file a certificate of conversion with the Florida secretary of state under F.S. [section] 608.439. For federal tax law purposes, the process is more involved and requires an evaluation of both the entity's present form of taxation and its existing tax attributes. Additionally, in the case of C corporations (such as those converting to limit their exposure under Pediatric), a material consideration is the exposure to the tax on built-in gains under Code [section] 1374, which, in most instances, represents the greatest source of potential tax liability and most weighty conversion-related cost consideration. (25)

Conclusion

Because of superior asset protection, limited liability, tax savings, and Pediatric, a substantial majority of Florida operating businesses will be best served by an LLC envelope. This conclusion assumes that most business owners will value one consideration above all others--namely, more money in their pocket as a result of the wage-reduction tax strategy.

C corporations operating as professional and other personal service businesses should assess their exposure to Pediatric and evaluate conversion to an LLC envelope.

Notwithstanding the appeal of the LLC envelope, such an entity may not be appropriate where the business cannot qualify as an S corporation, the one-class-of-stock rule interferes with business terms agreed to or desired by the owners, the business has considerable debt and the owner's anticipate significant losses, the business owns (or will own) appreciating assets, or the wage-reduction tax strategy will not benefit the owners. In addition, operating agreements for LLCs may be more complicated and expensive than shareholder agreements.

Finally, while the conversion of an entity into an LLC envelope can be complex, with careful planning, adverse tax consequences can be either minimized or eliminated.

(1) Treas. Reg. [section] 301.7701-3(a) enumerates certain types of organizations that must be classified as corporations, including without limitation, incorporated entities, joint-stock companies or associations, insurance companies, certain state-owned companies, and certain foreign entities.

(2) Statistics from the Division of Corporations of the Florida Department of State indicate that 135,578 corporations were incorporated in 2002, but only 38,639 LLCs. In addition, formbooks that include LLC operating agreements uniformly assume taxation as a partnership or disregarded entity. The authors are unaware of any formbook that includes an operating agreement that assumes taxation as a C or S corporation.

(3) For purposes of this article, federal employment taxes are a) Federal Insurance Contributions Act (FICA) under Code [section] 3101 et seq., b) Federal Unemployment Tax Act (FUTA) under Code [section] 3301 et seq., and c) self-employment tax under Code [section] 1401 et seq.

(4) See FLA. SWAT. ch. 608.

(5) See. e.g. Peter Spero, Asset Protection: Legal Planning Strategies and Forms [paragraph] 9.02 (Warren, Gorham & Lamont 2001) (citing Rev. Rul. 77-137 and Evans v. Comm'r, 447 F.2d 547 (7th Cir. 1971)); John R. Jones, Family Limited Partnerships Achieve Tax and Nontax Goals, 23 TAX'N FOR LAW 196, 200 (1994-95); but see Susan Kalintan, Assignment of an Interest in a Limited Liability Company and the Assignment of Income, 64 U. CIN. L. Rev. 443,522-29 (arguing that a creditor who obtains a charging order should not be treated as an assignee).

(6) An S corporation that allocates income to a creditor holding a charging order takes the position that the creditor is a shareholder for federal income tax purposes. Before taking such a position, the corporation should carefully evaluate whether treating the creditor as a shareholder adversely affects the corporation's S status.

(7) Hilton Oil Transp. v. Oil Transp. Co., 659 So. 2d 1141 (Fla. 3d D.C.A. 1995).

(8) FLA. STAT. [subsections] 620.8306 and 620.187.

(9) FLA. STAT. [section] 620.9003(5), (6).

(10) An LLC, however, cannot lose its limited liability shield. While the Florida secretary of state may administratively dissolve an LLC for failure to file--a punishment equivalent to revoking the statement of qualification for an LLP or LLLP--FLA. STAT. [section] 608.4482 provides that an LLC may be reinstated "at any time," with the reinstatement relating back to the date of dissolution.

(11) The contribution and benefit base under [section] 230 of the Social Security Act, which caps the Social Security component of the federal employment tax payments under Code [subsections] 1401(a), [section] 3101(a), and 3111(a) is $87,000 for 2003.

(12) Treas. Reg. [section] 1.707-1(c); Rev. Rul. 69-184, 1961-1 C.B. 256; GCM 35019, IRS GCM Sep. 01, 1972.

(13) This is the case particularly for those businesses with substantial collections produced as a result of the efforts of non-shareholder-employees, and with little or no administrative and nonbillable work performed by shareholder-employees.

(14) C corporations continue to possess advantages resulting from the tax treatment of the following minor fringe benefits: 1) out-of-pocket medial expenses; 2) employer provided meals and lodging; 3) [section] 125 cafeteria plans; 4) group term life insurance; and 5) accident insurance. Code [section] 1372; see generally William S. McKee et al., Federal Taxation of Partnerships and Partners [paragraph] 2.041[2] (3d ed. 1997). Notwithstanding, the preferential treatment accorded C corporations as a result of the above-listed fringe benefits, in most instances, this advantage is minor when compared to the tax savings available as a result of the wage-reduction tax strategy.

(15) An S corporation shareholder's pro rata pass through of net losses may not exceed the shareholder's basis in his or her shares of stock. Code [section] 1366(d). Moreover, the debt of an S corporation does not increase a shareholder's basis in his or her shares of stock. Code [section] 1367. Thus, if the owners anticipate that the total losses from an investment financed in part with debt will exceed their capital contributions and their shareholder loans to the corporation, losses may be trapped within the S corporation.

(16) The self-employment tax only applies to income from a "trade or business." In addition certain types of income, which are listed in Code [section] 1402(a), are excluded from self-employment tax. The most common exclusions are for investment income, such as rent, interest, gain or loss from the sale or exchange of a capital asset, and distributive share received by a limited partner. Where the anticipated income of a business falls within a [section] 1402(a) exception, the S corporation offers no federal employment tax advantage, and the owners should elect to be taxed as a partnership or disregarded entity, both of which offer greater flexibility than the LLC Envelope.

(17) Wages received from other sources by an employee-owner of an S corporation are not aggregated with the wages paid by the S corporation in determining the wage base limitations of FUTA or for the employer's portion of the Social Security component of FICA (collectively the "employer's portion"), but, rather, the wage base limitations for the employer's portion are calculated on a per-employer basis. Veterinary Surgical Consultants, P.C. v. Comm'r, 117 T.C. 141, 151 (2001). In contrast, all wages and self-employment income of partners and owners of disregarded entities are aggregated in determining the wage base limitation for the Social Security portion of the self-employment tax. Code [section] 1402(b). Thus, an employee-owner who has exceeded the wage base limitation can either: 1) elect to be taxed as a partnership or disregarded entity and avoid a second imposition of the employer's portion and continue to pay the 2.9 percent Medicare component without limitation; or 2) elect S corporation taxation, pay the employer's portion again on a reasonable wage, and utilize the wage-reduction tax strategy to limit further federal employment taxes. Thus, practitioners will need to compare these alternatives when analyzing which form of taxation is preferable.

(18) FLA. STAT. [section] 608.426 permits members to distribute capital and profits as they desire. Also, as long as the allocations have "substantial economic effect" as defined in Code [section] 704(b)(2), subchapter K of the Code

(which governs the taxation of partnerships) allows members to allocate taxable income and loss attributable to LLC operations in most any manner; whereas, Code [section] 1366(a) requires S corporation shareholders to take into account their share of the corporation's income and loss pro rata.

Sometimes, business terms negotiated by parties require profits, losses, deductions and distribution ratios among LLC owners to be different than the ratio of their contributions of capital. For instance, the owners can negotiate different priorities for the return of contributed capital, different rates of return on capital, and different allocations of profits and losses. An LLC taxed as a partnership cannot accommodate a vast array of such special provisions because of the pro rata share rule and the one class of stock rule.

(19) Rev. Proc. 93-27, 1993-2 C.B. 343, as clarified by Rev. Proc. 2001-43, 2001-2 C.B. 191.

(20) Appreciated property may generally be distributed without recognition of gain to the owners of an LLC taxed as a partnership. Compare Code [subsections] 731(a) and 736 with Code [subsections] 1371(a), 311(b), and 336.

(21) Compare Code [section] 1367 with Code [subsections] 722 and 752.

(22) See PLR 9404021 (Nov. 1, 1993).

(23) To divide appreciated property held by an S corporation amongst its shareholders, so that one or more shareholders can exit the venture and enter into separate like-kind exchange transactions, requires that the S corporation distribute either the original property or the replacement property to the exiting shareholder(s), which will trigger gain on the appreciation under either Code [section] 311(b) or [section] 336. Conversely, partners can generally distribute appreciated property without the recognition of gain, continue in their separate ownership long enough to satisfy the holding requirement under Code [section] 1031, and then enter into separate like-kind exchange transactions.

(24) The S corporation debt will not increase the basis of the shareholder's stock, and the shareholder will recognize gain on the distribution of loan proceeds, unless a preexisting basis in the stock exceeds the amount of the distribution. A shareholder may individually borrow money that the S corporation guarantees without gain, but the shareholder must be personally liable for the debt; otherwise, the loan proceeds will be treated as a constructive distribution. See Maher v. Comm'r, 469 F.2d 225 (8th Cir. 1972).

(25) Code [section] 1374 imposes a corporate-level tax on the built-in gain of an S corporation that was formerly a C corporation. In many cases, the accounts receivable of a corporation utilizing the cash method of accounting represents a source of built-in gait), that is difficult to manage. Accordingly, it is important to evaluate possible means to minimize built-in gains tax with respect to the accounts receivable of a corporation converting from C to S status.

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