

Tax Aspects of Pennsylvania LLC Documents

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Single Member LLC

- Will generally be disregarded entity for federal income tax purposes unless Form 8832 is filed to elect corporation status.
- No need for capital accounts, allocations, tax elections.
- Admission of second member will convert disregarded entity to partnership.
- Original member is deemed to contribute LLC assets to newly formed partnership.

Transition from Single Member LLC If New Member Makes Contribution

- Notwithstanding anything to the contrary, the company's first taxable year as a partnership for federal income tax purposes shall begin only once the company has two or more members, the original member shall be deemed to contribute the company's assets and liabilities to the partnership on such date, and capital accounts, profits and losses shall be determined accordingly.

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Alternative Language If New Member Purchases LLC Interest

- Notwithstanding anything to the contrary, the company's first taxable year as a partnership for federal income tax purposes shall begin only once the company has two or more members, the members shall be deemed to contribute undivided interests in the company's assets and liabilities to the partnership on such date, and capital accounts, profits and losses shall be determined accordingly.

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Pass-Thru Tax Treatment

- Income, gain, loss, deduction and credits of partnership flow through to partners.
- LLC members typically want to receive distributions at least sufficient to pay their taxes on LLC income. (pp. 301-02)
- Tax matters partner generally controls partnership federal income tax return, IRS audits, tax controversies.

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Tax Returns and Audits

- LLC agreement can address relationship between tax matters partner and other LLC members (pp. 302-04), including:
 - Obligation to file consistently with LLC returns
 - Notice of, and participation in, audits, administrative appeals and court proceedings;
 - Extension of statute of limitations;
 - Settlement of tax matters.

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“Check the Box” Elections

- LLC agreement generally precludes election of corporation status. (p. 303)
- Conversion to corporation is authorized in connection with IPO. (pp. 293, 303)
- Designed to be generally nontaxable under §351, with tacking of holding period for SEC Rule 144 purposes.
- Popular new alternative is UPREIT structure - e.g., Blackstone, Graham Packaging IPOs.

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Other Elections

- LLC agreement requires certain other generally desirable tax elections. (p. 303)
- §754 election will be made
 - at request of purchaser or estate that wishes to obtain inside basis step-up; or
 - upon a distribution that would result in basis step-up for remaining LLC assets. (p. 303)
- An alternative is to make these elections discretionary with board of managers or tax matters partner.

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Withholding Taxes

- Partnership generally must withhold federal income taxes at top marginal rate with respect to “trade or business” income allocable to foreign partners. IRC §1446.
- State withholding tax typically applies to income allocable to nonresident individual partners.
- Partnerships generally may file composite state tax returns for nonresident individual partners.
- LLC agreement requires member to reimburse for withholding taxes, with interest. (p. 304)

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Capital Accounts and Allocations

- LLC form agreements provide two alternative approaches.
- Full capital account and allocation provisions are provided in Annex B. (pp. 323-31)
- Abbreviated allocation provisions are provided in §4.04, Alternative B. (p. 300)

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Annex B Allocations

- “Targeted allocations” approach. (p. 327)
- This is designed to accommodate any agreed sharing of distributions.
- Annex B allocations incorporate typical provisions designed to comply with Treasury Regulations under IRC §704.

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§704(b) Requirements

- Liquidating distributions in accordance with capital accounts. (pp. 317-18)
- Allocations of losses to members who fund them with loans or guarantees. (p. 329)
- “Qualified income offset” and “minimum gain chargeback provisions.” (p. 328)
- Nonrecourse deductions are allocated based on percentage interests. (p. 329)
Could use capital contributions instead.

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§704(b) Book Values

- Capital account is increased by fair market value of contributed property.
- Capital accounts may be “booked up” in connection with subsequent issuance of LLC interests. (p. 325)
- Depreciation, gain and loss are based on “book value” for capital account purposes – not tax basis. (pp. 324-26)

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§704(c) & Reverse §704(c) Allocations

- Tax allocations are affected when tax basis and capital account book values differ. IRC §704(c).
- LLC member responsible for low-basis property generally bears the tax disadvantage of that low basis.
- LLC may choose method of §704(c) and “reverse §704(c)” allocations under Treas. Reg. §1.704-3. (p. 330)

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LLC Profits Interests

- May be issued as compensation for services without current tax, but provide opportunity for long-term capital gain.
- LLC agreement provides flexibility to issue profits interests. (p. 295)
- Liquidation value safe harbor election is provided so as to meet requirements of proposed regulations if finalized. (p. 331)
- Legislative proposals would tax all gain allocable to profits interests as compensation income.

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Other Tax Matters

- Fractions rule compliance for tax-exempt members in real-estate LLC to avoid UBTI from debt financing. (p. 329)
- Under “check the box” rules, there is no need to avoid “continuity of life,” “centralized management” or “free transferability of interests.” (pp. 285-86, 295-97, 316-17)
- Transfers may affect “publicly traded partnership” status under IRC §7704.

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