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Forming and Managing an LLC

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Issue Contents

Bankruptcy

- Federal taxation
- Sale of Chapter 12 estate property **91**

Federal Farm Programs

- Crop insurance **91**
- Federal Seed Act **91**

Federal Estate and Gift Taxation

- Alternate valuation date **91**
- GSTT **91**
- Gross estate **92**
- Valuation **92**

Federal Income Taxation

- Business expenses **92**
- Carbon dioxide sequestration credit **92**
- Charitable deductions **92**
- Dependents **92**
- Depreciation **93**
- Discharge of indebtedness **93**
- First-time home buyer credit **93**
- IRA **93**
- Innocent spouse relief **93**
- Partnerships
 - Check-the-box election **93**
 - Definition **93**
- Pension plans **94**
- Refunds **94**
- S Corporations
 - Election **94**
 - Officer compensation **94**
- Safe harbor interest rates
 - July 2011 **94**
- Social security benefits **94**
- Tax return preparers **94**
- Theft loss **95**
- Travel Expenses **95**
- Unemployment taxes **95**

In the News

- Payment limitations **95**

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Forming and Managing an LLC

-by Neil E. Harl*

Without a doubt, the limited liability company (LLC) has achieved a huge “market share” in organization of business entities, including farm and ranch businesses, in just over three decades.¹ Commencing with the first enactment of enabling legislation in 1977, by the turn of the century, all 50 states had enacted statutory authorization for the hybrid entity (some structural features and limited liability of a corporation and the tax status of a partnership), largely due to its unique features and because of its relative simplicity. However, the state-level enactments were far from uniform, and it was not until 1992 that a “Prototype Limited Liability Company Act” was proposed by a committee of the American Bar Association and the Uniform Limited Liability Company Act was promulgated by the National Conference on Uniform State Laws.²

Several states have now enacted second generation LLC Acts and a modicum of uniformity is emerging. Nonetheless, the interrelationships of LLC law and tax law continue to raise significant issues which are important in forming and managing an LLC.

Decisions on entity classification

An issue that arises almost immediately in the process of forming an LLC is the matter of the tax classification of the entity. Effective in 1997, the Internal Revenue Service and the Department of the Treasury adopted a proposal to simplify entity classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis.³ The options came to be known as the check-the-box procedure. In effect, the regulations allow a business entity not required to be treated as a corporation to choose its classification.

Under the regulations, a business entity that is not specifically classified as a corporation can elect its initial classification *with four possible changes by election* in addition to the default rules.⁴

Default rules. Under the default rules, a domestic eligible entity is treated as a partnership for tax purposes if the entity has two or more members.⁵ The entity is disregarded as an entity separate from its owners for federal tax purposes if the entity has a single owner⁶ or a two-member LLC if one of the members has no economic interest in the entity.⁷

Partnership electing to be an association. Under an election by a partnership entity to shift to being taxed as an association, the partnership contributes all assets and liabilities to the association (which means corporate taxation) and the partnership liquidates by distributing the stock of the association to its partners.⁸

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Association electing to be a partnership. The association distributes all of its assets and liabilities to its shareholders (in a corporate liquidation) and the shareholders contribute all of the distributed assets and liabilities to a newly-formed partnership.⁹

Association electing to be a disregarded entity. The association distributes its assets and liabilities to a single owner in liquidation of the association (in a corporate liquidation).¹⁰

Disregarded entity electing to be an association. The owner of an eligible entity contributes all assets and liabilities of the entity to an association in exchange for stock of the association.¹¹

Change in classification

A change of classification can be made by filing Form 8832, Entity Classification Election.¹² The election is effective on the date specified in the election or the date filed if no date is specified.¹³ If an entity makes an election to change its classification, *the entity cannot change its classification again for 60 months* (unless there is a change in ownership of more than 50 percent).¹⁴ A change in the number of owners of an entity does not, however, result in the deemed creation of a new entity for purposes of the 60-month limitation.¹⁵

Tax consequences of change in classification

The regulations make it clear that the tax treatment of a change in classification of an entity for federal tax purposes is determined under the Internal Revenue Code “and general principles of tax law.”¹⁶ That appears to mean any change in classification of an association (taxed as a corporation) to a partnership-type entity would be subject to corporate liquidation rules. Likewise, any change to a new type entity faces the regular rules on entity formation and the regular rules applicable to entity liquidation.

Other conversions

Partnership to LLC. The conversion of a general or limited partnership to an LLC taxed as a partnership can be accomplished without recognition of gain or loss.¹⁷ Upon conversion, the tax year of the converting partnership does not close with respect to any or all of the partners and the resulting LLC does not need a new taxpayer identification number.¹⁸

LLC to partnership. No gain or loss is ordinarily recognized on contribution of LLC property (which had been under a partnership classification) to a general or limited partnership in exchange for a partnership interest.¹⁹

Merger of S corporation into an LLC. On the merger of an S corporation into an LLC, IRS has ruled that the transaction is treated as a transfer of assets to the LLC followed by a distribution of the interest to the S corporation shareholder or shareholders with gain recognized as though the S corporation had sold the property to the shareholder at the time of the distribution.²⁰ A merger of an S corporation into a disregarded entity (LLC) was treated as a deemed sale of assets.²¹ However, in a 2005 letter ruling, an S corporation conversion into an LLC was considered a type F reorganization²² with no gain or loss recognized.²³ The same result obtained on conversion of

an S corporation into an LLC taxed as an association in a 2008 ruling.²⁴

Changes needed in operating agreement

If an LLC commences operations under the default provision (taxed as a partnership), as is often the case because of the likelihood of start-up losses in the early years of the entity), the initial operating agreement typically reflects partnership tax treatment. A later election to shift to taxation as an association with a filing of Form 8832 may require amendments to the operating agreement in implementation of the shift in classification.

ENDNOTES

¹ See 2 Harl, *Farm Income Tax Manual* § 6.09[1][a] (2011 ed.). See generally 2 Harl, *Farm Income Tax Manual* § 6.09 (2011 ed.); 8 Harl, *Agricultural Law* § 61.03 (2011); Harl, *Agricultural Law Manual* § 7.05 (2011).

² See Harl, “Limited Liability Companies,” in Hoff, ed., *Illinois Tax Book*, Ch. 4 (2008).

³ 61 Fed. Reg. 66,584, Dec. 18, 1996. See Notice 95-14, 1995-1 C.B. 297.

⁴ See *Litriello v. United States*, 484 F.3d 372 (6th Cir. 2007), cert. denied, 2/19/08 (check-the-box regulations upheld).

⁵ Treas. Reg. § 301.7701-3(b)(1)(i).

⁶ Treas. Reg. §§ 301.7701-3(b)(1)(ii), 301.7701-2(a).

⁷ E.g., Ltr. Rul. 9911033, Dec. 18, 1998. See CCA 200501001, September 21, 2004 (IRS unable to ascertain whether LLC was single or had multiple members in face of conflicting evidence and testimony; involved father and son).

⁸ Treas. Reg. § 301.7701-3(g)(1)(i).

⁹ Treas. Reg. § 301.7701-3(g)(1)(ii).

¹⁰ Treas. Reg. § 301-7701-3(g)(1)(iii).

¹¹ Treas. Reg. § 301.7701-3(g)(1)(iv).

¹² Treas. Reg. § 301.7701-3(c)(1)(i).

¹³ Treas. Reg. § 301.7701-3(c)(1)(iii).

¹⁴ Treas. Reg. § 301.7701-3(c)(1)(iv).

¹⁵ Treas. Reg. § 301.7701-3(f)(3).

¹⁶ Treas. Reg. § 301.7701-3(g)(2)(i).

¹⁷ E.g., Ltr. Rul. 200414013, Dec. 10, 2003 (conversion of general partnership to LLC; partners’ capital accounts in LLC same as capital accounts in partnership).

¹⁸ Ltr. Rul. 9809003, March 18, 1997 (conversion of two-person general partnership to LLC tax-free); Ltr. Rul. 9841030, July 14, 1998 (same).

¹⁹ E.g., Ltr. Rul. 9720008, Feb. 4, 1997.

²⁰ Ltr. Rul. 9543017, July 26, 1995.

²¹ Ltr. Rul. 200628008, March 28, 2006.

²² I.R.C. § 368(a)(1)(F).

²³ Ltr. Rul. 200528021, April 8, 2005.

²⁴ Ltr. Rul. 200839017, June 24, 2008.