PROFESSIONAL EDUCATION BROADCAST NETWORK

CHOICE OF ENTITY – A FRESH LOOK; TAX & NON-TAX CONSIDERATIONS

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CHOICE OF ENTITY – A FRESH LOOK;
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I. INCOME TAX CONSIDERATIONS.

A. Tax Rates.

1. Personal Income Tax.

The top individual rate initially was 7% for incomes in excess of $500,000. Revenue Act of 1913, § 2A, 38 Stat. 114, 166 (1913), which is over $10 million in today's dollars. The top rate increased to 67% during World War I in 1917 and reached 94% during World War II.

The Economic Recovery Tax Act of 1981 ("ERTA") reduced top individual rate to 50%. The Tax Reform Act of 1986 ("TRA") reduced the maximum individual rate to 28%. The top rate was increased to 31% and then 39.6%, and then reduced to its current 35%. Assuming that the Bush tax cuts expire as scheduled, it will increase to 39.6% in 2011. The effective top marginal rate will then be 41% for taxpayers in states that impose state income taxes because the 3% reduction in itemized deductions will apply. I.R.C. § 68; Pub. L. No. 107-16, § 901.

2. Corporate Income Tax.

The corporate income tax originated in 1909, imposing a 1 % tax on corporate income over $5,000. The tax rate rose to 12% by 1918, and remained at roughly that level until the late 1930's, when a series of rate increases increased the top tax rate to 40% in 1942. The tax rate increased in 1951 to over 50%, and did not return to below 40% until 1988. The 34% top rate applicable in 1988 has remained consistent with only a one percent increase in 1993 to the current 35%.

3. Capital Gains & Dividends Tax.

Special treatment for capital gains began in 1922 with an alternative tax rate of 12.5% for assets held for at least two years and evolved into a 50% exclusion in 1942, and increased to 60% in 1978. The net capital gain was later eligible for a special top rate of 20%, which in turn was adjusted down to 15% with the Jobs and Growth Tax Relief Reconciliation Act in 2003. I.R.C. § 1(h)(1)(C).

The top tax rate for dividends paid by C corporations was reduced to the preferential rate for net capital gain of 15%. The top rates for net capital gain and C corporation dividends will increase in 2011 to 20% and 39.6%, respectively.

4. Health Reform – New Medicare Taxes On High Income Taxpayers In 2013.

Under current law, wages are subject to a 2.9% Medicare tax. Workers and employers pay 1.45% each. Self-employed people pay both halves of the tax (but are allowed to deduct half of this amount for income tax purposes). Health Reform, The Patient Protection And Affordable Care Act ("PPACA"), adopts the Senate proposal to increase an employee's share of Medicare from 1.45% by 0.9 percentage points, to a total 2.35 percent for high-income workers in 2013. The employer's share remains at 1.45%, making the total tax paid for high-income individuals 3.8%. That would be added to the worker's top marginal rate, which will rise to as much as 39.6 percent in 2011 as the Bush tax cuts expire. The extra .9% tax is also added to the self-employment tax (SECA) and is not deductible, increasing that tax from 2.9% to 3.8%.

An increased 3.8% Medicare tax is imposed by IRC § 1411 on investment income of individuals, trusts, and estates. Beginning in 2013, it is supposed to generate an estimated $210 billion to help fund health care reform. This is the largest tax increase in the health reform law and raises over half of the new revenue. It would push tax rates on capital gains and dividends to 23.8 percent in 2013 for high-income people if Congress goes along with Obama's proposal to let those rates rise to 20 percent in 2011 from the current 15 percent as the Bush cuts expire. This would be the highest rate for long-term capital gains since 1997. Overall tax rates on income from interest, annuities and royalties would rise to a maximum of 43.4 percent (39.6% + 3.8%).

The tax does not apply to trades or business income of a sole proprietor, partnership, or S corporation. In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity that is not property attributable to an active trade or business is taken into account.

Income, gain, or loss on working capital is not treated as derived from a trade or business. However, distributions of S corporation income (dividends for state law purposes) will be subject to this tax to the extent from investment income. Income that could be paid as salary or a distribution by an S corporation to a high-income individual would be taxed at 3.8% in either case. If it is a dividend, it is subject to a 3.8% tax but only to the extent that it is from investment income. If is compensation from a corporation, the corporation pays 1.45% and the individual pays 2.35%. If it is self-employed income, it is taxed at 3.8%. Previously, in an entity taxed as a partnership, if some of the income is self-employment income, then all of it is self-employment income. That apprently will now be different and like an S corporation. Previously, there was no bifurcation of active and investment income in a partnership as there can be for shareholder-employees.

Example. If in 2013 your share of an S corporation's profit is $100,000 and $80,000 of this $100,000 represents profits from the business operation, with $20,000 of profit coming from dividends, interest and capital gains on investments held by the S corporation, no matter whether you're a working shareholder or a passive shareholder, you'll pay the expanded Medicare tax on the $20,000 of investment income that flows through to you if your income exceeds the $200,000 or $250,000 threshold amounts. A proposed new tax, discussed below, would apply to the $80,000 amount if enacted for certain S corporations engaged in personal services.

In the case of an individual, the tax is the 3.8 percent of the lesser of net investment income (investment income less deductions allocated to producing it) or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

Investment income is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents (other than income derived from any trade or business to which the tax does not apply); (ii) other gross income derived from a trade or business is that is a passive activity (within the meaning of section 469) with respect to the taxpayer, or trading in financial instruments or commodities (as defined in section 475(e)(2) per IRC § 1411(c)(2); and business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.

The term "net investment income" does not include any distribution from a retirement plan or arrangement described in IRC § 401(a), 403(a), 403(b), 408, 408A, or 457(b). IRC § 1411(c)(5).

Gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax.

For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas the self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes. Thus, investment income does not include amounts subject to SECA tax. IRC § 1411(c)(6).

Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income). IRC § 1411(d).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

The tax does not apply to a non-resident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. IRC §1411(e). The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any income tax.

B. Relative Rates.

The relative rates are important for choosing among the various entity types that are available. The basic choice for tax purposes is between the pass-through treatment for partnerships and S corporations and the potential lower rates (except for personal service corporations) and double tax of the C corporation. Prior to TRA 1986, most businesses, especially profitable ones, were conducted through C corporations.

The primary reason for many closely-held businesses choosing this form of entity was that the C corporation marginal rates were significantly lower than those for individuals. Prior to ERTA, The Economic Recovery Tax Act of 1981, the top corporate and individual rates were 46% and 70%, respectively; ERTA reduced the top individual rate to 50%. TRA 1986 lowered the top marginal individual income tax rate to 28%, and the top corporate rate was 34%. For the first time since 1913, closely-held businesses electing pass-through status could pay less tax on income passed through from an S corporation or partnership, as well as avoiding the potential second tax that would have been triggered by the distribution of those earnings from the entity if it were a C corporation.

The 1986 changes fueled the popularity of pass-through entities. As a result of the 1986 changes, the trend has been toward pass-through taxation, through the use of partnerships or entities taxed like partnerships or S corporations. In the former category are limited liability companies and actual partnerships (general partnerships, limited partnerships, limited liability partnerships, and in some states, limited liability limited partnerships) that have not elected to be taxed as corporations. In the S corporation category are state law corporations that have made the S election as well as limited liability companies and partnerships that have elected both to be treated as S corporations. S corporations have represented a majority of all corporate returns and remained very popular among the pass-through entities. One, reason has been the ability to make S distributions (state law dividends) without Medicare tax that would apply if the amounts were paid in addition to compensation over the Social Security Wage base. A second reason is the ability to avoid double taxation on the sale of assets.

C. Reasons Favoring C Corporation Status.

1. Public Company Or Company Planning To Go Public.

The largest category of entities that are taxed as C corporations is publicly-traded entities. Most of these entities have many more than the maximum 100 shareholders that are allowed for corporations to elect S status, and are per se corporations; therefore, they are not eligible to elect out of corporate status in order to achieve partnership treatment. Widely held partnerships (including limited liability companies not electing to be treated as corporations) have only slightly more flexibility. If any of their interests are "traded on an established securities market" or "readily tradable on a secondary market (or the substantial equivalent thereof)," then, with limited exceptions, they too will be taxed as corporations. I.R.C. § 7704(a) & (b). There are exceptions for partnerships whose gross income consists at least 90% of "qualifying income" (interest, excluding financial or insurance business interest, dividends, real property rents and gains, mineral or natural resource income and commodities income in certain circumstances). Id. There is also an exception for certain electing 1987 partnerships. I.R.C. § 7704(g).

2. Existing C Corps; Problems With Changing Status.

In addition, there are a number of corporations that had C status prior to TRA 1986, and have not converted to some form of pass-through entity because converting from corporate to partnership status will be treated as a liquidation and trigger two levels of taxation, one at the entity level and one at the individual level. See I.R.C. §§ 336(a), 331(a). Other C corporations that could qualify for S corporation status have in some cases not converted because of the built-in gains tax. This tax effectively imposes a double tax regime on all gain that is "built-in" as of the beginning of the corporation's first taxable year as an S corporation. It only lasts for a period of 10 years (7 years for taxable years beginning in 2009 and 2010), and only applies to recognized built-in gains in excess of recognized built-in losses during that period. See I.R.C. § 1374(d)(2) & (7). There are circumstances, often involving accounts receivable for cash basis taxpayers and inventory, where the potential cost of converting to S status under the built-in gains tax is for some not worth the more uncertain benefits of the single-tax S corporation. There are also circumstances where the single class of stock, shareholder eligibility, and excluded corporation requirements of S corporation status prevent the conversion of C corporations. See I.R.C. §§ 1361(b)(1)(B)-(D), (2).

3. Section 1202 Small Business Stock Exclusion.

In order to qualify for the section 1202 exclusion, the entity issuing the stock must qualify as a C corporation "during substantially all of the taxpayer's holding period for such stock." See I.R.C. § 1202(c)(2)(A). Thus, an individual forming a business, or investing substantial funds in it, always needs to balance the somewhat more favorable combined income/self-employment top marginal tax rates for S corporations against the benefits of this exclusion, which is only available to C corporations.

There is a 5 year holding requirement.

Until February 18, 2009, the exclusion was 50% of any gain from the sale or exchange of qualified small business stock held for more than 5 years but that percentage was raised to 75% for stock acquired after February 17, 2009 and before January 1, 2011 For purposes of calculating eligible gain under this provision, pre-contribution gain on property used to acquire the qualified small business stock, or contributed to the capital of the C corporation, is excluded. See I.R.C. § 1202(i). HR 4853, the "Middle Class Tax Relief Act of 2010" and "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" increased the exclusion to 100% for all qualified small business stock issued after September 27, 2010, and before January 1, 2012, which is held for a minimum of 5 years.

In order to qualify as "qualified small business stock," stock must be issued after August 10, 1993 directly to the selling taxpayer at original issue in exchange for money or other property (other than stock) or services (other than as an underwriter of the qualified small business stock). See I.R.C. § 1202(c)(1). If a taxpayer is acquiring stock that would otherwise qualify, except for the fact that some of the consideration is ineligible stock or services, then the taxpayer should split the acquired stock into two blocks. If qualified small business stock is converted into other stock in the same corporation, the new stock shall be treated as such and as having been held during the period the converted stock was held. See I.R.C. §1202(f).

At issuance, the corporation itself must be a "qualified small business." Thus, it must be a domestic corporation that has not had more than $50 million of aggregate gross assets since August 10, 1993 and will not surpass that amount "immediately after the issuance." In addition, the corporation must agree to submit reports to the Secretary and shareholders as required. See I.R.C. § 1202(c)(1), (d).

"During substantially all of the taxpayer's holding period for such stock," the corporation must be actively engaged in the conduct of one or more qualified trades or businesses. This means that 80% (by value) of the assets of the corporation must have been used in such active conduct, though there are special rules for start-up activities, research and experimental expenditures, and in-house research expenses. See I.R.C. § 1202(e)(1).

Qualified trades or businesses <u>exclude</u> the following: (a) health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any other trade or business where the principal asset is the reputation or skill of one or more of its employees; (b) banking, insurance, financing, leasing, investing or similar businesses; (c) farming; (d) production or extraction of depletable resources and; (e) hotels, motels, restaurants and similar businesses. See I.R.C. § 1202(c)(3). Additionally, the corporation cannot be a DISC or former DISC, a possessions corporation (or the parent of one), a regulated investment company, a real estate investment trust, a REMIC or a cooperative. See I.R.C. § 1202(e)(4).

Not more than 10% of the value of the corporation's net assets in excess of liabilities can consist of stock or securities of other non-subsidiary corporations. See I.R.C. § 1202(e)(5)(C). Presumably, bank accounts do not constitute "securities in other corporations," and corporations with low net worth would be well advised to stay away from any investments in other corporations.

Not more than 10% of the corporation's total assets, by value, can consist of real property not used in the active conduct of its business, which, in turn, cannot consist of "ownership of, dealing in, or renting of real property." See I.R.C. § 1202(e)(7).

After an initial start-up period of two years, no more than 50% of the assets of the corporation can consist of cash. See I.R.C. § 1202(e)(6).

There are requirements relating to redemptions. First, during the four-year period surrounding the issuance of such stock (two years before and two years after), the corporation cannot have "directly or indirectly" redeemed more than $10,000 worth or 2% of the outstanding stock owned by the taxpayer and related persons. See I.R.C. § 1202(c)(3)(A); Treas. Reg. § 1.1202-2(a). Second, during the two-year period surrounding issuance (one year before and one year after), the corporation cannot have redeemed stock valued in excess of 5% of the aggregate value of all of the corporation's stock as of the beginning of such two-year period. Note that this could be a problem if the value of the stock increases dramatically during that period. In addition, the rule could be violated even before the taxpayer purchases his or her stock. For purposes of both of the foregoing requirements, transfers of stock by shareholders to employees or independent contractors are ignored, notwithstanding the fact that they may be treated as the acquisition and reissuance of the stock by the corporation under section 83 of the Code. See Treas. Reg. § 1.1202-2(c).

In addition, there are exceptions for stock redeemed upon termination of employment, death, disability and divorce. See Treas. Reg. § 1.1202-

All of these requirements are apparently intended to prevent the indirect sale of stock by one shareholder to a new shareholder, thereby defeating the "original issuance" requirement described above. These rules require constant monitoring.

In addition to the C corporation and five-year holding period requirements, the section 1202 exclusion is also subject to some monetary limits. However, the limits are fairly generous. At a minimum, at least $10 million gain is eligible on a cumulative basis for each corporation in which the taxpayer invests.[1] Thus, taxpayers should be entitled to at least up to $7.5 million of exclusion for investments made in a qualified small business stock of any given corporation between now and January 1, 2011. Moreover, even this limit is increased so that the taxpayer's entire gain will be eligible for the partial (or possibly complete) exclusion unless his or her return on investment is greater than 10 to 1. See I.R.C. § 1202(b)(1).

Although the current rule is that only 7% of the excluded gain will be treated as a tax preference for AMT purposes, this provision expires on December 31, 2010, at which point the preference will be increased to 28% for stock acquired after December 31, 2000, and to 42% for stock acquired before that. See I.R.C. § 57(a)(7); Pub. L. No. 108-27 § 303(b)(3)(A)-(B), as amended by Pub. L. No. 109-222 § 102. Here again, however, President Obama has proposed eliminating this preference entirely.

In conclusion, section 1202 stock is unlikely to offset the benefits of a single level of tax in a pass-

[1] There is parent-subsidiary but not brother-sister, aggregation. See I.R.C. § 1202(d)(3).

through entity upon sale unless (a) a stock sale or tax-free reorganization is the more likely form of disposition or (b) tax at the corporate level upon sale will not be a significant issue for some other reason (e.g., substantial net operating loss carryforwards). In those circumstances where coupling C corporation status with the section 1202 exclusion might be beneficial, an analysis of the after-tax results of ongoing operations as a C corporation vs. S corporation/partnership should be made, along with a careful determination of whether the technical requirements of small business stock qualification can be satisfied with a reasonable level of certainty.

4. No Medicare tax for owners on employer's retirement plan contribution (applies to S corporation also) or employer's payments for health, dental, vision or other types of insurance.

For married owner making $250,000 or more with a retirement plan contribution of $49,000, this will be an annual savings of $1,862 per owner [3.8% times $49,000] as opposed to any other entity.

5. Use Of Losses.

Owners may prefer to accumulate losses at the corporate level so that they can be used to shelter income at the entity level later.

6. Accumulation At Lower Tax Rate.

There are also small businesses (not, however, personal service corporations ("PSCs"), i.e., those engaged in health, law, engineering, etc. that are taxed at a flat 35% federal rate) that would prefer to accumulate up to $50,000 a year at the low 15% rate (I.R.C. § 11(b)(1)(A), (2) for use in the business, despite the fact that there may be an additional second tax sometime in the future on dividends or sale of assets. This may be easier to accomplish in settings where compensation is low enough so that it can be adjusted to prevent corporate income from hitting the 25% ($50,001-$75K), 34% ($75,001-$100K) and 39% ($100,001- $335K) rates.

This advantage must be weighed against the disadvantage of double tax on dividends or sale of assets and liquidation.

7. Fringe Benefits For Owner-Employees.

There are also other situations, including professional service corporations, where the majority of the available cash is paid out in taxable compensation, and the treatment of certain fringe benefits is available only for "employees" (e.g., medical reimbursement, cafeteria plan, disability insurance, group term life insurance) is still more favorable for C corporation shareholder-employees. See I.R.C. §§ 1372, 79, 105, 125.

Until the advent of PPACA, this differential between proprietors, partners, more than 2% shareholders of S corporations and C corporation shareholder-employees was no longer applicable with respect to health insurance. I.R.C. § 162(l). Under PPACA (ERISA 715; IRC 9815), there is a new nondiscrimination requirement for health insurance for years beginning after Sept 23, 2010, although it does not apply to any group health plan in existence on March 23, 2010 that qualifies as a "grandfathered plan." Where the new nondiscrimination requirement does apply, it can likely be avoided by the use of the new simple cafeteria plan that becomes available beginning in 2011 under Code § 125(j), thereby allowing shareholder-employees of regular C corporations (but not owners of other entities except 2% or less shareholder-employees of S corps) to continue to enjoy preferential health insurance benefits. However, it may be necessary for a technical amendment to add new Code § 9815 to the list of nondiscrimination requirements that are deemed to be met.

8. Simple Cafeteria Plans Available In 2011; Owners Can Only Be Covered In C Corporations.

The health reform law includes a provision creating "simple cafeteria plans" under IRC § 125(j) for small businesses, effective for years beginning in 2011. Simple cafeteria plans automatically meet nondiscrimination requirements applicable to cafeteria plans if they meet minimum eligibility, participation, and contribution requirements. This safe harbor covers the regular cafeteria plan nondiscrimination requirement of section 125(b), the 25% concentration test, and the nondiscrimination requirements of 79(d), 105(h), and 129(d) applicable to group term life insurance, a self-insured health insurance or medical reimbursement plan, and dependent care assistance benefits (child care).

Where a business wants to avoid the 25% concentration test and contribute for owner-employees, only a regular C corporation can do so.

Under 125(h)(3), a "qualified benefit" does not include any qualified health plan as defined in section 1301(a) of the Patient Protection and Affordable Care Act or "PPACA") offered through an Exchange unless the employer is a qualified employer under 1312(f)(2) of PPACA offering the employee the opportunity to enroll through such an Exchange in a qualified health plan in a group market.

<u>Avoiding New Health Insurance Nondiscrimination Requirements</u>. Simple cafeteria plans, available for plan years beginning in 2011, offer a work around to the new health insurance nondiscrimination rules applicable to all employer insured plans on and after Sept. 23, 2010 other than grandfathered plans. In addition, these plans allow shareholder-employees and other key employees to benefit under the plan and be exempt from the regular cafeteria plan rule that limits benefits for such individuals to 25% of the total nontaxable plan benefits – the so-called concentration test.

Until Sept. 23, 2010, a partnership or corporation can pay 100% of family coverage for partners or shareholder-employees, and 50% of single employee coverage for staff that are not insured through a spouse. The employer can pay for and deduct insurance only for owner-employees. Thereafter, such an employer can do so only with a grandfathered plan in existence on March 23, 2010. A simple cafeteria plan in 2011 and thereafter can get the same result if the employer is a regular C corporation, although will not be exactly equivalent, as formula for employer contribution will be 2% (or more if desired) with all eligible employees, including the shareholders, paying for whatever health insurance they select with pre-tax dollars.

The simple cafeteria plan eliminates the new health insurance nondiscrimination requirement because it automatically meets 125(b) and 105(h). Could the IRS argue that 105(h) only applies to self insured plans. Even though that new IRC 9815 incorporates 2716 of the PHSA, which in turn incorporates IRC 105(h), it does so for insured plans. So do we fail 9815 and thus simple cafeteria plan rules if the employer does not contribute same dollar amount for each eligible employee? Do we fail because the salary reduction contributions are treated as employer contributions where, for example, the same benefit options are available but all HCEs buy family coverage NHCEs buy only single coverage or nothing? The answer should be no to both questions, as the intent was to give a pass to all nondiscrimination requirements, but a technical correction to include Code § 9815 is needed to make that clear. Alternatively, if the regulations under 125(j) or 9815 provide that the nondiscrimination requirement is met based on eligibility rather than use of benefits, as is the case under 105(h), then the nondiscrimination requirement should be easy to meet.

The simple 125(j) rules give a free pass on 79, and 105(h), 125(b), and 129 (and hopefully 9815) testing for nondiscrimination, even if most health insurance costs is paid by employees, if they so elect, by salary reduction. Therefore, the simple cafeteria plan should pass testing if it offers all participants eligibility under the simple rules and offers the same benefits to those similarly situated. Under 105(h), only the benefits offered are tested. All benefits provided for highly compensated employees and their dependents are also offered for all other participants and their dependents. Reg. §1.105-11(c)(3)(i) provides: "This test is applied to the benefits subject to reimbursement under the plan rather than the actual benefit payments or claims under the plan." Similarly, Reg. §1.105-11(c)(3)(ii) states: "The determination of whether plan benefits discriminate in operation in favor of highly compensated individuals is made on the basis of the facts and circumstances of each case. A plan is not considered discriminatory merely because highly compensated individuals participating in the plan utilize a broad range of plan benefits to a greater extent than do other employees participating in the plan."

<u>Technique Only Available Practically For Smaller Employers Without Penalty</u>. For businesses that have 50 or more FTE employees, if an employee voluntarily opts out of the employer's plan and goes to an exchange to obtain an individual subsidized health insurance plan (the subsidies go as high as income of $88,000 for a family of 4) then the employer has to pay a penalty for those who don't take the plan and get a government subsidy in connection with purchasing a plan from a state-exchange. However, the benefits of the simple cafeteria plan may outweigh any penalty in certain situations.

<u>100 Or Fewer Employees</u>. An employer is eligible to implement a simple cafeteria plan if, during either of the preceding two years, the business employed 100 or fewer employees on average (based on business days). For a new business, eligibility is based on the number of employees the business is reasonably expected to employ. Businesses maintaining a simple cafeteria plan that grow beyond 100 employees can continue to maintain the simple arrangement until they have exceeded an average of 200 or more employees during a preceding year. Employees include leased employees.

<u>Controlled & Affiliated Service Groups One Employer</u>. The employer aggregation rules under IRC Sections 52 (applying the rules of section 1563, except "more than 50 percent" is substituted for "at least 80 percent" in section 1563(a)(1), and subsections 1563(a)(4) and (e)(3)(C) are disregarded) and 414 (controlled and affiliated service groups) apply for purposes of determining an eligible employer. Additionally, an employer includes a "predecessor employer," which term is undefined.

<u>Simple Cafeteria Plan Eligible "Employees</u>." All non-excludable employees who had at least 1,000 hours of service during the preceding plan year must be eligible to participate in a simple cafeteria plan. The new rules continue the regular cafeteria plan requirement that to a participant can only be an "employee" and thus excludes partners, LLC members taxed as partners, 2% or more owners of S corporations, and sole proprietors.

<u>Simple Cafeteria Plan Qualified Employees</u>. The term "qualified employee" means any employee who is not a highly compensated employee under section 414(q) or key employee under section

416(i) and who is eligible to participate in the plan.[2] This definition of qualified employee is relevant only to the two alternative minimum contribution requirements, discussed below, and that HCEs and key employees may participate like everyone else so long as they are "employees" and do not receive disproportionate employer regular or matching contributions.

Section 125(j)(3)(C) allows comparable contributions for HCEs and key employees, as it provides: Subject to subparagraph (B)(regarding matching contributions), nothing in this paragraph shall be treated as prohibiting an employer from making contributions to provide qualified benefits under the plan in addition to contributions required under subparagraph (A). The required contributions in (A) are for "qualified employees" but the employer contributions for at least 2% of pay are for all employees under (A)(i), not just qualified employees, and (B) indicates that matching contributions can be made for HCEs and key employees.

Simple Cafeteria Plan Excludable Employees. Excludable employees are those who:

- have not attained age 21 (or a younger age provided in the plan) before the *end* of the plan year;
- have less than one year of service as of any day during the plan year;
- are covered under a collective bargaining agreement; or
- are nonresident aliens.

An employer may have a shorter age and service requirement but only if such shorter service or younger age applies to all employees.

Employees who previously worked 1000 in a plan year but do not currently can be excluded, as employees who do not have a year of service in the current plan year can be excluded. However, since the rule is that they can be excluded if they do not have a year of service on any day in the year, they will have 1000 hours if they go from full time to part time at the beginning of the current year. This is an important point where the employee's salary is less than the health benefits. They should be entitled to the entire maximum benefit if elected, even if greater than their compensation in order to safeguard simple status.

Benefit Nondiscrimination. Each eligible employee must be able to elect any benefit under the plan under the same terms and conditions as all other participants.

Minimum Contribution Requirement. The minimum must be available for application toward the cost of any qualified benefit (other than a taxable benefit) offered under the plan.

Employer contributions to a simple cafeteria plan must be sufficient to provide benefits to non-highly compensated employees (NHCEs) under 125(j)(3)(A) of at least either:

For 2010, an individual is an HCE if his or her compensation from the same employer in 2009 exceeded $110,000 or the person is an officer, more than 5% owner, a spouse or dependent working for the same employer. For 2010, an individual is a key employee if:

- An officer earning more than $160,000 in the 2009 plan year; or
- A more than a 5% owner; or
- A more than a 1% owner receiving compensation in excess of $150,000 in the prior plan year.
- Government entities do not have Key Employees.

(i) A uniform percentage of at least two percent of compensation (defined as it is under 414(s) for retirement plan purposes, whether or not the employee makes salary reduction contributions to the plan; or

(ii) The lesser of a 200% matching contribution or six percent of the employee's compensation. Under 125(j)(C), additional contributions can be made, but the rate of any matching contribution for HCEs or key employees cannot be greater than the rate of match for NHCEs under 125(j)(B).

The same method must be used for calculating the minimum contribution for all NHCEs. The rate of contributions for key employees and HCEs cannot exceed that for NHCEs. Compensation for purposes of this minimum contribution requirement is compensation with the meaning of section 414(s).

<u>Safe Harbor From Nondiscrimination Rules.</u>

Simple cafeteria plans are treated as meeting the nondiscrimination requirements of IRC Section 125(b), including the concentration test that currently limits key employees' benefits to 25% of the total of nontaxable benefits provided for all employees under the plan.

Nondiscrimination tests applicable to individual benefits are deemed to be satisfied, including the Section 79(d) rules for group-term life insurance, the Section 105(h) rules for self-insured medical expense reimbursement plans, and the dependent care rules of Section 129(d)(2),(3) and (8).

These nondiscrimination rules have discouraged utilization of cafeteria plans by small businesses. For example, if a small office with two key employees and two non-key employees provided identical dollar amounts of benefits to all employees under a cafeteria plan, the 25% concentration test would be failed because 50% of total benefits go to the key employees. The new simple cafeteria plan safe harbor addresses this problem but only for small employers organized as traditional C corporations since only common law "employees" and not the self employed are eligible. Multiple classes of owners permitted (applicable also for entities other than S corporations).

D. Reasons Favoring Any Pass-Through (S Corporation, LLC, LLP, etc) Over C Corporation.

1. No double taxation upon an asset sale, unlike a C corporation.

2. Losses flow through to owners annually (up to amount of basis).

3. No risk of unreasonable compensation resulting in double taxation as in C corporation for compensation paid to owner-employee.

4. No accumulated Earnings Tax

For C corporations, IRC §§ 531-537 provide that from 2003 through 2010, the accumulated earnings tax is 15 percent on earnings a corporation accumulates above $250,000 without a valid business purpose. The limit is $150,000 for certain personal service corporations (i.e., corporations in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, where the owners provide the services). In 2011, the tax rate reverts back to the highest individual rate, which will be 39.6 percent if the law does not change. This tax does not apply to LLCs or other entities not taxed as corporations.

This tax is designed to dissuade corporations from accumulating earnings just to avoid paying taxable dividends. However, this tax is usually easy to avoid, for three reasons:

- Earnings can be reduced to zero, through the withdrawal of earnings in deductible ways such as higher (reasonable) compensation for the owners.
- The corporation can accumulate earnings beyond these limits, provided it can prove it has a business need to do so, such as payment of anticipated future operating expenses, a planned business expansion, etc.
- The corporation can elect to be treated as a conduit for tax purposes, by making a subchapter S election, which eliminates this problem.

5. Personal Holding Company Tax

A regular C corporation is a Personal Holding Company (referred to as an “incorporated pocketbook”) if at any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned, directly or indirectly, by no more than 5 individuals. In addition, at least 60% of the corporation’s "adjusted ordinary gross income" must consist of passive investment income (dividends, interest, annuities, rents, royalties (other than mineral, oil and gas, copyright, or computer software royalties), capital gains, etc) or from personal services performed by a major shareholder. I.R.C. §§ 542, 543. Real estate rents do not count if they are more than 50% of the adjusted ordinary gross income but any other passive income more than 10% of AOGI must be paid out. Banks and insurance companies are not subject to the PHC tax.

When computing the personal holding company's taxable income, several adjustments are made. Net long term capital gains are excluded, the "regular income tax paid” is deducted, and the 80% dividends-received deduction is added back. The tax is not imposed on dividends paid to shareholders.

The PHC tax is 39.6%. The penalty tax of 39.6% is applicable in addition to the corporate tax. This penalty tax is applied to the corporate taxable income, less distributions to shareholders, income taxes, and certain other adjustments. The tax applies to foreign and domestic companies alike, and is in addition to the regular corporate tax.

<u>Adverse Impact On Tech Startup Licenses</u>. This tax can apply to tech startups that license technology. For example, NewDrugCo decides to license its second patent to Big DrugCo for a large lump sum payment of $3,000,000 in hopes of using the money to develop its first patent over the next few years. This is particularly important because the founders will own only 60% of NewDrugCo after the angel funding and, thus, they want to avoid the need to seek venture capital investment at this stage. When NewDrugCo closes the license deal with Big DrugCo, NewDrugCo will be subjected to potential penalty tax liability for 15% of “undistributed personal holding company income.” The solution of course is not to use a C corporation.

E. Reasons Favoring S Status Over C Corporation & Other Pass-through Entities.

1. Ability for high income shareholder employees, active in business, to receive dividends not subject to Medicare tax from distributions from business as opposed to investment income. Such distributions are exempt from the new Medicare tax after

2012 on business income paid as a distribution (dividend) but not on investment income paid as a distribution.

2. No Medicare Tax For Owners On Employer's Retirement Plan Contributions (applies for shareholder-employees of C corporations also).

F. Reasons Favoring Partnerships & Entities Taxed As Partnerships.

1. Ability to avoid application of 409A for retiring partners/members by use of 736 payments.

2. Ability to avoid self-employment income tax to retiring general partners who are paid some amount until death under 1402(a)10).

3. Opportunity for person buying in to obtain increased basis on entity assets through 754 election and re-depreciate them.

4. Pass-Through Tax Desired & Owners Include Ineligible S Corporation Owner.

5. LLPs for multistate professional firms avoid state qualification and licensing issues that may apply to PCs and LLCs.

6. Special allocations of income to owners desired.

7. Entity debt creates owner basis, unlike in S corporation.

8. Refinancing proceeds can be distributed income tax free.

9. Multiple classes of owners permitted (applicable also for C corporations).

This 1402(a)10) exclusion for lifetime payments to retired general partners (which also applies to LLC member-managers) is not available to severance payments to shareholder-employees of corporations. Under IRC § 1402(a)(10) and Reg. 1.1402(a)-17(c)(1), exclusion of payments to "general partners" from self employment tax is an all-or-nothing proposition as to whether payments on account of retirement received by a retired partner during the tax year of the partnership are excluded. On retirement, a "general partner" can exclude from NEFSE (income subject to self-employment tax) amounts received if the requirements of IRC § 1402(a)(10) and Reg. 1.1402(a)-17 are met, namely:

(1) The payments must be received by the partner pursuant to a written plan of the partnership.

(2) The payments must be made on account of retirement, on a periodic basis, to partners generally or to a class or classes of partners, with the payments continuing at least until the partner's death. These payments can be front loaded. See PLR 200403056, where most of the payments were made in the first 5 years after retirement and $100 a year thereafter.

(3) The partner must render no services with respect to any trade or business carried on by the partnership during the tax year of the partnership in which the amounts were received.

(4) No obligation may exist as of the close of the partnership's tax year from the other partners to

the retired partner except with respect to retirement payments under the plan.

(5) The partner's share, if any, of the capital of the partnership must have been repaid in full before the close of the partnership's tax year in which such amounts were received.

(6) The retired partner must have no financial interest in the partnership except for the right to retirement payments.

If payments are not made to the retired partner on a periodic basis that continue at least until the partner's death (but rather terminate after a fixed number of years), the former general partner will include the retirement payments in NEFSE. If the partner has a right to a fixed percentage of any amounts collected by the partnership after the date of retirement that are attributable to services rendered prior to her retirement to clients of the partnership, the payments received by her for that tax year are not excluded from NEFSE since, as of the close of the partnership's tax year, an obligation (other than an obligation with respect to retirement payments) exists from the other partners to the retired partner. See Reg. 1.1402(a)-17(c)(2), Example (3).

PLR 9630012 ruled that an active member in an accounting firm LLP who carries management rights and actively participates in the accounting business of the firm will have NEFSE on his entire distributive share of income from the firm, and that none of his income will be excluded under Section 1402(a)(13). This indicates that an active member of an LLP (which is treated as a general partnership for state law purposes) is neither a limited partner nor treated as a limited partner for purposes of Section 1402. See Shop Talk, "Are Retirement Payments to Limited Partners and LLC Members Subject to Self-Employment Tax?," 86 JTAX 62 (January 1997).

<u>LLP General Partner Qualifies</u>. PLR 9630012 holds that payments made on account of a retired partner of an LLP that meet the requirements of Section 1402(a)(10) will be excluded from NEFSE.

<u>LLC Member Qualifies</u>. PLR 200142004 ruled that Section 1402(a)(10) relief is available for payments to an attorney who was a retired member of an LLC classified as a partnership for federal income tax purposes. The LLC maintained a retirement benefit program for its members (treated as partners for tax purposes) that provided for payments directly from the law firm to the retiree. On retirement, the retired partner relinquishes her interest in the LLC, in exchange for the balance of her capital account in the firm, the retirement benefits under the nonqualified retirement program, and other benefits payable under the firm's benefit plans. The retired partner is entitled to a retirement payment equal to the sum of the average of the partner's three highest distributions for any previous calendar year. The amount is paid out, without interest, in a series of monthly payments for a period of not less than 60 and not more than 120 months. Thereafter, the retired partner is entitled to payments of no less than $100 per month for the rest of the partner's life.

After describing the requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17, the letter ruling concludes that the LLC's retirement program is a bona fide retirement plan within the meaning of Section 1402(a)(10), and meets the other requirements of the statute and the Regulation. In connection with the requirement that the payments by a partnership must continue at least until the partner's death, the ruling observes that although the payments by the LLC are likely to be reduced after the initial 60–120 month period, the monthly payments thereafter will never fall below $100 per month and will continue until the retired partner's death. The letter ruling is consistent with the Service's position (in earlier letter rulings) involving redemptions of general partners in a general partnership agreement in not requiring level, equal amounts of retirement benefit payments throughout the retired partner's lifetime. A step-down in the amount is permissible as long as the payments are retirement payments for at least the duration of the retired partner's life.

The ruling expresses no opinion as to the treatment of the payments to the retired partners under any provision of the Code other than Section 1402(a)(10).

Retirement Payments To Limited Partners. Limited partners may enjoy an exemption from NEFSE during the period they are limited partners. Section 1402(a)(13) provides that NEFSE does not include the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services. Section 1402(a)(13) (then numbered (a)(12)) was added to the Code by P.L. 95-216, 12/20/77 (the Social Security Amendments of 1977); prior to that time, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership was included in NEFSE, and some limited partners made passive investments in limited partnerships solely to become insured for Social Security benefits by incurring NEFSE while performing no services for the partnership. See Banoff, "Tax Distinctions Between Limited and General Partners: An Operational Approach," 35 Tax Law Review 1 (Fall 1979), pages 76-77.

However, a limited partner who actively renders services (permitted in many states without serious risk of unlimited personal liability, pursuant to the Revised Uniform Limited Partnership Act) and receives Section 707(c) guaranteed payments for services determined without regard to partnership income will receive NEFSE. Any remaining share of income as a limited partner will not be NEFSE. Section 1402(a)(13); Reg. 1402(a)-1(b). Moreover, if the limited partner does not receive a Section 707(c) payment, i.e., does not receive compensation determined "without regard to partnership income," but rather merely receives her distributive share of income (e.g., a percentage of net profits) for services, no portion of her compensation constitutes NEFSE.

What is the treatment of retirement payments made to a limited partner who rendered services while a partner, but who had received an allocable share of partnership net income as remuneration for services and never received guaranteed payments for services under Section 707(c)? While a partner, such service provider would have no NEFSE pursuant to Section 1402(a)(13). Does the answer change with respect to payments made to the (former) limited partner on retirement? If the retirement payments meet all of the aforementioned requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17, the payments clearly are not NEFSE. If, however, the retirement payments did not qualify for Section 1402(a)(10) treatment, the answer is less clear. Prop. Reg. 1.1402(a)-2 does not permit a service partner in a service partnership to be a "limited partner" for purposes of Section 1402(a)(13). See Prop. Reg. 1.1402(a)-2(h)(5). If this proposed rule were adopted and applicable, the pre-retirement payments to such a limited partner would be NEFSE.) No cases, rulings, or regulations under Section 1402(a)(13) deal with payments to retired limited partners.

G. 736 Payments & Service Partnership Buyouts; Planning Important; Issue As To LLCs.

Code § 736 applies to transactions treated as a liquidation (redemption) of a partner's interest in the partnership. If a written buyout agreement and the partnership agreement of a service partnership do not contain any purchase price allocation for the redemption (liquidation) of a retiring partner, the net fair market value of the equipment, furniture and other tangible assets is a capital gain payment. The partnership can make a 754 election and amortize those assets. The balance of the payments is ordinary income because they will be characterized as relating to accounts receivable or unstated goodwill. Moreover, they are deductible to the partnership.

IRC § 736 dictates how liquidating final payments to the retiring partner or estate are classified. For tax purposes, the payment, whether in the form of cash or property, is considered either a payment for the partner's share of partnership property or something other than his or her share of partnership property. The purpose of the section is to ensure that retiring partners correctly classify certain items as ordinary income.

In 1993, Congress enacted Section 736(b)(3), which curtailed the flexibility of capital partnerships to choose the tax consequences of payments made in redemption of a partner's interest in partnership goodwill. Prior to this legislation, Section 736(b)(2) allowed all partnerships a choice between treating payments for goodwill as capital or ordinary items by allowing the partnership agreement to control the outcome. Section 736(b)(3) eliminated this choice for partnerships other than service partnerships. The House Ways & Means Committee reasoned that "general partners in service partnerships do not ordinarily value goodwill in liquidating partners. Accordingly, such partners may continue to receive the special rule of present law."

Service partnerships are those in which capital is not a material income producing factor. Sec. 736(b)(3)(A). For this purpose, capital is not a material income producing factor where substantially all the gross income of the business is derived from fees, commissions, or other compensation for personal services performed by individuals. Thus, a professional practice of a doctor, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor, even though the practitioner has a substantial investment in professional equipment or in a physical plant constituting the professional office, so long as the capital investment is only incidental to the professional practice. H Rept No. 103-111 (PL 103-66) p. 783.

Code Sec. 736(b)(3) provides that if capital is not a material income-producing factor and the partner is a general partner, Code Sec. 736(b)(2) automatically applies ordinary income treatment to the unrealized receivables and unstated goodwill. Unstated goodwill is goodwill for which the partnership agreement contains no provision for payment.

All payments, fixed or contingent, are 736(b) payments to the extent of the value of the partner's percentage share of the net fair market value of partnership assets. However, payments for receivables and unstated goodwill (where there is no dollar allocation to goodwill in the operating or purchase agreements) to a general partner in a service partnership with no allocation of value, which are treated as 736(a) payments.

Section 409A does not apply to an arrangement that provides for section 736 payments unless the arrangement provides for payments for life that qualify under 1402(a)(10), which are excluded from self-employment tax. See Notice 2005-1 Q&A-7.

Section 736(a)(1) payments reduce the total amount of partnership income that would otherwise have been allocated to the remaining partners while Section 736(a)(2) payments result in a partnership-level deduction. The partnership deducts the 736(a) payments when made, which may be before or after the income as collected by the partnership, which is when it is taxed. Payments for substantially appreciated inventory and recapture items are payments for property that are

736(b) payments but taxed under 751(b) as ordinary income.

<u>736 & LLCs (Taxed As Partnerships</u>). Where there is no contrary written agreement, the probable correct result for the treatment of a redemption of a personal service LLC member is that the redeemed member's share of the net fair market value of the LLC's assets is a capital gain payment under section 731 and 736(b) (and not deductible by the LLC), with the balance of the payment being a guaranteed payment under 736(a), which is ordinary income to the member bought out and deductible to the LLC.

<u>Service LLC Members Should Not Be Treated As General Partners.</u> The only basis for this proposition is that a member of an LLC is not treated as a general partner of a partnership because the member is not a "general partner" under state law,. While the IRS has not ruled on this issue, a manager-member or a member of a member managed LLC should be treated as a general partner for this purpose, based on the purpose of the provision, IRS rulings in an analogous area, and four court cases, all discussed below.

<u>Service LLC Members Should Be Treated As General Partners</u>. "At least some LLC members, particularly managers and manager-managed LLCs and probably all members and member-managed LLCs should qualify, as should almost all partners and LLPs, since LLPs generally operate under the same partnership acts as general partnerships, with the only difference being limited liability obtained by filing an appropriate document." 811 BNA T. M. Portfolio A-120 (2009).

Second, 736(b) payments are by definition distributions made in exchange for the retiring member's interest in LLC assets, and, therefore, any payment in excess of a member's share of LLC assets cannot be treated as a Section 736(b) payment. Therefore, in the event that such a premium is paid for a member's interest in the LLC that exceeds the value of the member's share of the LLC's assets, that premium should be treated as a Section 736(a) deductible to the extent of the value of accounts receivable and the balance of the payment if there is no allocation in the operating agreement or a separate agreement to goodwill.

Third, the answer lies in whether the LLC member is more like a general partner or a limited partner for (purposes of) Section 736(b). Understanding that basically there are only two differences between a general and a limited partner—unlimited liability and the right to participate in management—and understanding that a member of an LLC may have the right to participate in the management and business of the company (like a general partner) and limited liability (like a limited partner), whether a member is treated as a general partner or as a limited partner in any given instance depends on which of these two characteristics is critical in treating general partners and limited partners differently in that case.

Fourth, the reason for the carve-out for general partners in Section 736(b)(3)(B) for Section 736(b)(3)(A) service organizations is the service element and not the liability element. Thus, the fact that a general partner has unlimited liability and that an LLC member has limited liability is irrelevant. Accordingly, there is no reason to treat LLC members any differently than general partners where the LLC members are entitled to provide services on behalf of the firm, as would a lawyer for a law firm. Therefore, it is my conclusion that professional LLCs may use Section 736 now as they have always, pursuant to Section 736(b)(3).”

Fifth, the IRS has treated an LLC member as a general partner in a similar context. On retirement, a general partner can exclude from self employment tax amounts he receives if the requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17 are met. In a private letter ruling, the IRS treated an LLC member as a general partner for this purpose. In Ltr. Rul. 200142004, Section 1402(a)(10) treatment was granted for payments to an attorney who was a retired member of an LLC classified as a partnership for federal income tax purposes. The retired partner is entitled to a retirement payment for life and the other requirements of Section 1402(a)(10) and Reg. 1.1402(a)-17 were met. The letter ruling concludes that the LLC's retirement program is a bona fide retirement plan, within the meaning of Section 1402(a)(10), and meets the other requirements of the statute and the Regulation.

Sixth, while the IRS has not yet ruled on the characterization of an unallocated liquidation payment attributable to the self-created goodwill of an LLC, which is paid to a retiring LLC manager or actively participating LLC member. However, Treasury in the self-employment arena has in proposed regulations put LLCs and partnerships on equal footing, which indicates that the Code Sec. 736(b)(3) choice should be available to a “personal service” LLC.

Seventh, the courts have ruled that LLC members are not limited partners. Thus, if they are not limited partners, they are general partners, which is the only other choice. The basic reason for the courts’ holding is that unlike limited partners, LLC members can participate in the governance and operations of the LLC. In *Garnett v. CIR*, 132 TC No 19, 2009 WL 1883965 (2009), and *Thompson v. CIR*, 87 Fed Cl 728 (Fed. Cl. Ct., 2009), the Tax Court and the Court of Federal Claims rejected the Service's attempt to treat both the members of LLCs and the partners in limited liability partnerships (LLPs) as limited partners for purposes of the passive loss rules. The courts concluded that, absent direct statutory or regulatory guidance, the taxpayers could not be treated as subject to the more restrictive rules applicable to limited partners under Section 469. This was also the result in *Hegarty v. CIR*, TC Summary Opinion 2009-153 and *Gregg v. CIR*, 186 F Supp 2d 1123 (DC Ore. 2000).

<u>Service Partnerships-Capital Not Material Income Producing Factor</u>. In the case of a retiring or deceased general partner of a service partnership, one in which capital is not a material income-producing factor, 736(b) payments do not include payments made for such partner's interest in the partnership's unrealized receivables (not including recapture items) under § 751 and goodwill unless there is a specific allocation to goodwill in the partnership agreement, in which case the goodwill payments are also § 736(b) payments. It is probably sufficient for the agreement to be in a separate redemption agreement as well. See *CIR v. Jackson Investment Co*., 346 F.2d 187 (9th Cir. 1965).

Section 736 gives the partners in service partnerships significant flexibility to determine whether distributions are deductible ordinary income payments under section 736(a) or payment for the withdrawing partner's interest in partnership property under 736(b).

<u>Example</u>. <u>Unrealized Receivables</u>. A service partnership has three equal partners and $90,000 cash, cash method receivables of $222,000, and supplies that were properly deducted when acquired and are worth $9,000. One partner is read deemed for a payment of $107,000 in cash. The

supplies are substantially appreciated inventory because their sale would produce ordinary income and their fair market value exceeds 120% of the zero adjusted basis. 751(b) treats the redeemed partner as having received $3000 for the supplies. The redeemed partner's outside basis is $30,000, so $30,000 of cash is tax-free. The remaining $74,000 of the payment is for the receivables and is treated as ordinary income under 736(a), a guaranteed payment, and not under 751(b). The partnership steps up its basis in the supplies by $3000 and can take a deduction for the "purchase" of those supplies. See BNA 811 T. M. Portfolio at pages A-119 – 120 (2009).

<u>Example</u>. <u>Receivables &</u> <u>Unspecified Goodwill</u>.

A service partnership with three equal partners redeems one partner for $150,000. The partnership has $90,000 cash and cash-method receivables worth $111,000 with a zero basis. The partnership determined the amount paid based on the redeemed partner's $30,000 capital account with the balance based on an earnings formula. There is goodwill because the amount paid is in excess of the redeemed partner's capital account plus the partner's $37,000 share of accounts receivable. No amount is allocated by the partnership agreement or separate agreement to the receivables or goodwill. The $30,000 payment allocable to the partner's capital account is a 736(b) liquidation distribution with a gain or loss determined by that amount less the partner's outside basis. The balance, $120,000, is a section 736(a)(2) guaranteed payment, taxed as ordinary income to the redeemed partner and deductible to the partnership. The receivables are not taxed under 751(b). If the agreement had specified an amount for goodwill, it would have been a 736(b) capital payment amortizable by the partnership over 15 years. Accounts payable and similar obligations of a cash-method partnership that have not been deducted are not liabilities. However, if they are not transferred to the partner (who could deduct them one the partner pays them) but are taken into account in determining the amount of the liquidating distribution, they reduce the ordinary income because 736(b) payments come first. See 811 BNA T.M. Portfolio A-121 (2009).

<u>Example</u>. <u>Service Partnership With Bank Debt</u>

A service partnership with three equal partners redeems one partner. Neither the partnership agreement nor any separate agreement makes any allocation of the purchase price. The partnership has cash and other assets look the value of $90,000, cash-method accounts receivable of $180,000, bank debt of $60,000, and accounts payable of $18,000 deductible only when paid. The redeemed partner's capital account is $30,000, and has outside basis in the partnership interest is $50,000. The partnership redeems his interest for $64,000 in cash and agrees to indemnify him for the bank debt and the payables. The taxable distribution is $64,000 plus $20,000 of debt relief (the payables are not debt for this purpose) for a total of $84,000. $30,000 of the payment is based on the value of assets and taxed under 736(b). The remaining $54,000 is 736(a)(2) guaranteed payment, taxed as ordinary income to the redeemed partner and deductible to the partnership. This is amount is less than is one-third share of receivables because his $6,000 share of the payables was netted against that value. See 811 BNA T. M. Portfolio A-121 (2009).

H. Passive Losses, LLCs and LLPs Better Than LPs For Those Wanting Current Losses.

Under Code Section 469, passive losses may offset only passive income. Unless a partner can demonstrate his material participation, his share of the partnership's loss a passive activity loss rather than an ordinary loss. Section 469(c)(1)(B). In *Garnett v.CIR*, 132 TC No 19, 2009 WL 1883965 (2009), and *Thompson v.CIR*, 87 Fed Cl 728 (Fed. Cl. Ct., 2009), the Tax Court and the Court of Federal Claims rejected the Service's attempt to treat both the members of LLCs and the partners in limited liability partnerships (LLPs) as limited partners for purposes of the passive loss rules. The courts concluded that, absent direct statutory or regulatory guidance, the taxpayers could not be treated as subject to the more restrictive rules applicable to limited partners under Section 469. This was also the result earlier in *Gregg v.CIR*, 186 F Supp 2d 1123 (DC Ore. 2000).

Members of LLCs and partners in LLPs are not "limited partners" under the passive activity rules of Section 469 based on recent cases. It is not clear how general partners of a limited liability limited partnership (LLLP) should be treated for purposes of 469.

Section 469(a) provides a limitation on the ability of certain taxpayers to use losses or credits from passive activities in determining their income. A passive activity is defined in Section 469(c) as any rental activity or any trade or business activity in which the taxpayer does not materially participate.

Section 469(h)(1) provides that a taxpayer materially participates in an activity only if he is involved in the activity's operations on a regular, continuous, and substantial basis. Section 469(h)(2) provides, however, that (except as provided in Regulations) "no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."

Losses from limited partnership interests are not available to offset positive income from other sources. The Senate committee incorrectly assumed that income allocable to a limited partner automatically was passive due to the nature of limited partnerships and the inability of limited partners to participate actively in an activity if they wish to maintain limited liability status. In many states, limited partners can now participate in management. S. Rep't No. 99-313, 99th Cong., 2d Sess. 716 (1986).

1988 Temporary Regulations are still the latest interpretation and define material participation. Temp. Reg. 1.469-5T(a) lists seven tests for determining whether an individual materially participates in an activity; a taxpayer must satisfy one of these tests. Specifically, an individual may establish his material participation in an activity for a given tax year by demonstrating any of the following:

(1) The individual participated in the activity for more than 500 hours during such year.

(2) The individual's participation in the activity for the tax year constituted substantially all of the participation in such activity of all individuals for that year.

(3) The individual participated in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year was not less than the participation in the activity of any other individual for that year.

(4) The activity was a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during that year exceeded 500 hours.

(5) The individual materially participated in the activity for any five tax years during the ten tax years that immediately preceded the tax year.

(6) The activity was a personal service activity, and the individual materially participated in the

activity for any three tax years preceding the tax year.

(7) Based on all facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during that year.

On the other hand, if an individual is a limited partner in a partnership, Temp. Reg. 1.469-5T(e)(2) provides that the individual can materially participate in an activity only if the first, fifth, or sixth test above is met. Thus, an individual who participates for less than 500 hours in the tax year in an activity in which the taxpayer is a limited partner generally cannot materially participate in the activity (unless the taxpayer materially participated in the activity in prior years), whereas a taxpayer can establish material participation on several other bases if the individual is not a limited partner (e.g., is a general partner).

Temp. Reg. 1.469-5T(e)(3)(i) defines an interest in an entity taxed as a partnership as a "limited partnership interest" if either of the following conditions is met:

(1) The interest is designated as a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under state law.

(2) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the state in which the partnership is organized, to a determinable fixed amount (e.g., the sum of the holder's prior capital contributions and contractual obligations to make additional capital contributions to the partnership).

Temp. Reg. 1.469-5T(e)(3)(ii) provides that if a person is both a general partner and a limited partner in the same partnership, the limited partnership interest will not be treated as a limited partnership interest for these purposes.

Newer Limited Partnerships

Under subsequent revisions of the uniform limited partnership act, i.e., RULPA 1976, RULPA 1985, and ULPA 2001, limited partners in many states can now participate in significant activities of the limited partnership, without loss of limited liability.

LLLPs

An LLLP is a limited partnership whose general partners are also shielded from personal liability for some or all of the partnership's debts. The shield already exists with respect to the LLLP's limited partners, of course, although in some instances the vicarious liability protection afforded limited partners in an LLLP is thought to be slightly greater than under traditional limited partnership law.

I. Service Firms Practicing as LLLPs.

1. Tax consequences of converting to an LLLP.

Assume a professional services firm is already operating as a general partnership. What are the tax consequences of its decision to operate as an LLLP? Specifically, is the conversion of the general partnership into LLLP form a taxable event, and what are the collateral tax consequences?

Tax-Free Conversion From Entity Taxed As Partnership. Rev. Rul. 95-37 ruled that a conversion of a general partnership into an LLC was governed by Section 721 (providing neutral consequences to the partners and the unincorporated entities), and determined that the particular form used to convert the general partnership into an LLC did not affect the tax consequences (effectively, permitting the substance of the conversion to control over the form). Similarly, in Rev. Rul. 95-55 ruled that the registration of a general partnership as an LLP pursuant to that state's law was a Section 721 transaction based on Rev. Rul. 84-52 and Rev. Rul. 95-37. No Revenue Rulings or letter rulings are known to have been issued to date with respect to changes of existing partnerships, LLCs, or LLPs into LLLP status. Nonetheless, there appears to be no reason why the IRS would not apply a similar favorable Section 721 analysis to conversions into LLLPs.

The tax consequences of operation of a professional services firm in LLLP form remain unclear. While "partnership" and "partner" are defined for tax purposes, "general partner" and "limited partner" are not. "Partnerships" and "partners" are included in Section 761 and Reg. 1.761-1 by reference to the Regulations under Section 7701. Section 7701(a) defines "partner" to include a member in a syndicate, group, pool, joint venture or other unincorporated organization.

2. Tax Issues In Operating LLLP.

A professional firm considering operation as an LLLP must deal with the following tax and related issues:

State Law Status Of Limited Partners. Are the limited partners of the LLLP treated for tax purposes as "limited partners" because they are members of an entity organized under a state's limited partnership laws, even though the partners will actively provide services and may take part in the firm's management?

Tax Status Of General Partners. Are the general partners of an LLLP treated for tax purposes like "general partners" because of their title and managerial authority and powers or "limited partners" because of their limited liability under the LLLP shield?

Self Employment Income. Will the income of the limited partners in the LLLP constitute net earnings from self-employment (NEFSE)? Section 1402(a)(13) provides that the distributive share of any item of income or loss of a limited partner is excluded from the computation of NEFSE, other than guaranteed payments for services to the limited partner. If so, the professionals who are limited partners in an LLLP would not pay SE taxes on their distributive share of partnership income and those amounts would not be eligible for retirement plan contributions, eliminating social security and Medicare tax until the law changes in 2013 under the 2010 health reform legislation.

Liquidation Payments Upon Termination Repurchase Of LLLP Interest. The rule is that Section 736 payments to a partner are not deductible by the payor partnership pursuant to Section 736(b)(2). Section 736(b)(3), however, provides an exception for such payments to a “general partner” of a partnership for which capital is not a material income-producing factor. That qualification is important because the service firm typically is using operating revenues (ordinary income, taxable to the remaining partners) to pay the withdrawn partner. By qualifying under Section 736(b)(3), professional service partnerships generally structure payments to a retired or deceased partner in a manner that allows the partnership to have a deduction for the ordinary income paid to the exiting partner, with the remaining partners to obtain tax-advantaged treatment for the departed partner's share of payments for goodwill or unrealized receivables.

This same issue of 736 application has been cited by some general partnership service firms as a factor in their converting into LLP (rather than LLC) form, given the continuing uncertainty of whether LLC members are "general partners" for this purpose. There is no clear resolution on this issue yet. There is a good case that 736 should be available to LLCs and LLLPs.

Cash Method Accounting. Section 448 permits qualified personal service corporations and partnerships to use the cash method. Professionals typically use this method because collections occur after the right to income is earned. Sections 446, 448, 461, 464, and 1256 provide that a partnership or other pass-through entity cannot use the cash method if more than 35% of the losses of such entity during the tax year are allocable to limited partners or limited entrepreneurs.

Temp. Reg. 1.448-1T(b)(3) provides that a partnership or other entity may fail this test only if more than 35% of the losses during the tax year are actually allocated to limited partners and limited entrepreneurs. Therefore, assuming the other requirements of Section 448 are met, an LLLP, like an LLC, arguably should not lose the cash method under Section 448 before the first year in which it incurs losses in excess of income and more than 35% of such losses are allocated to the limited partners. See PLRs 9321047 and 9415005.

Will The LLLP's Trade Or Business Be Imputed To Its Limited Partners? The question of whether a limited partnership's trade or business is imputed to "active" limited partners is not settled. *Butler v. CIR*, 36 TC 1097 (1961), acq., held that a lawyer who was an "active" limited partner in a business limited partnership could deduct his unpaid loan to the LP as a business bad debt. Imputation to "active" limited partners in a professional service LLLP would seem to be similarly appropriate.

However, TAM 9728002 held that the partnership's trade or business should not be imputed to limited partners, but only to general partners, in connection with the attempted deduction of legal fees incurred by a limited partner in a lawsuit against the general partner, thereby resulting in a Section 212 itemized deduction rather than a Section 162 above-the-line deduction. The Service limited *Butler* to its facts because Butler was more than a passive investor—he was a key member of the firm "and more like a general partner even though labeled a limited partner." Many if not all service LLLP partners arguably will be as active as general partners in a service LLP, and thus imputation of trade or business status may be appropriate, even under TAM 9728002.

State Income Tax. Finally, for state and local tax purposes, will the LLLP be treated as a limited partnership, in those jurisdictions where entity-level taxes are applied to certain types of pass-through entities (e.g., LLCs) but not to limited or general partnerships? Moreover, in those jurisdictions where limited partnerships may be subject to entity-level taxes and withholding on distributions to limited partners (but the same rule does not apply to general partnerships), does operation as an LLLP provide a tax disadvantage?

Similarly, will those out-of-state individual service partners who are limited partners in the LLLP be less likely to have a nexus with other states, for purposes of multistate jurisdiction or taxation? In states where the service firm does business and that state's individual income tax rate is materially greater than the home state tax rate of the LLLP limited partner, can the latter validly avoid taxation or nexus on his allocable share of the LLLP's net income attributable to the high tax rate state?

J. Reducing Self Employment (SECA) Tax.

As noted above, payments to limited partners and perhaps to members of LLCs other than for management services may be exempt from self employment tax except to the extent that they are payments for services. This concept was attempted to be implemented in *Robucci v. Cir*, T.C.

Memo. 2011-19 (January 24, 2011) holds that (1) the new structure of a sole proprietor psychiatrist's practice should be largely disregarded as without substance, (2) the taxpayer continues to be taxable as a sole proprietor, and (3) the 6662 substantial understatement penalty applies. This case follows a much different path than numerous earlier cases upholding conversions of sole proprietorships and partnerships into professional corporations. The entities involved were not implemented properly. The court notes that if they had been, the result might have been different. This reminds us of the early PC days, where the IRS was on the attack and successful taxpayers were careful to dot every "I" and cross every "T."

Robucci P.C. was wholly owned by Dr. Robucci, and this PC was a co-member, along with Dr. Robucci personally, in Tony L. Robucci, M.D. LLC (Robucci LLC). Dr Robucci personally owned 95% of the LLC and his PC owned 5%. Dr. Robucci 's 95-percent interest in the LLC was divided between a 10-percent general partner interest and an 85-percent limited partner interest attributable to Dr. Robucci 's personal goodwill. Westsphere was a management corporation wholly owned by Dr. Robucci. The PC and Westsphere are referred to as the corporations.

The IRS argued and Tax Court Judge Halpern held that the corporations should be disregarded, leaving the Robucci LLC as a SMLLC owned solely by Dr. Robucci. Thus, as footnote 2 of the decision noted, the court did not need to deal with the two IRS alternative 482 and 269A arguments, both typically unsuccessful in prior litigated cases.

<u>The Taxpayer's Goal – Tax Reduction</u>.

During his first meeting with Mr. Carson, an attorney and CPA, sole proprietor Dr. Robucci stated that he wanted to do what was best from the standpoint of his own personal tax planning and wanted to minimize the amount of taxes he was paying. Mr. Carson recommended the organizational structure described above. That discussion covered structuring Dr. Robucci's practice so as to reduce self-employment tax while also minimizing other tax liabilities. Dr. Robucci did not seek a second opinion from any other C.P.A. or attorney, nor did Mr. Carson provide him with a written explanation of the need to form three separate entities. Carson explained orally to Dr. Robucci that the LLC would conduct the practice, that for reasons not made clear to Dr. Robucci, it needed to have two members (Dr. Robucci personally and Robucci P.C.), and that Westsphere would be a business management corporation and not involved in providing patient care.

<u>Failure To Implement Mr. Carson's Recommended Organizational Structure</u>

Dr. Robucci was the sole shareholder of both corporations. During that same period, Robucci LLC was 95-percent owned by Dr. Robucci and 5-percent owned by Robucci P.C. The court says that Robucci P.C.'s interest was as a limited partner. This seems to be incorrect, as footnote 4 of the decision notes that Reg. § 301.7701-3(b)(1)(i) states that a multimember LLC that does not elect association status (which describes Robucci LLC) is treated, for Federal tax purposes, as a partnership. Thus, Robucci LLC's members would most likely both constitute general partners for Federal tax purposes if it were respected as a two-member entity. Several court decisions hold that LLC members cannot be limited partners, even if they are merely members in a manager managed

LLC. However, the IRS has never issued final regulations on this issue. The court's reasoning also makes this issue moot in this decision.

Dr. Robucci's 95-percent ownership interest was reflected on Robucci LLC's partnership returns as an 85-percent interest as a limited partner and a 10-percent interest as a general partner. While not noted by the court, many cases hold that LLC interests of members in a manager managed LLC are not limited partner interests but rather general partner interests. Carson based his determination of an 85-percent limited partner ownership interest for Dr. Robucci on the value of Dr. Robucci's goodwill and what would be a reasonable rate of return on that goodwill at the time he formed Robucci LLC. Mr. Carson never discussed with Dr. Robucci the basis for the 85-percent-10 percent allocation between his limited and general partner interests in Robucci LLC. Dr. Robucci did understand that his 10-percent general partnership interest represented his interest as a provider of medical services and his 85-percent limited partnership interest represented his interest attributable to his capital contribution of intangibles.

Carson did not prepare a written valuation report to support his conclusions. Additionally, Dr. Robucci did not make any written assignment of the tangible or intangible assets of his practice to Robucci LLC.

Westsphere executed a loan agreement, whereby Dr. R as an "employee" was authorized to borrow money from Westsphere "from time to time" under specified terms and conditions.

Dr. Robucci executed an Employee Business Expense Reimbursement Plan, whereby Westsphere agreed to reimburse its employees for all employment related expenses upon submission of the proof of expenditure documentation specified in the plan. Westsphere also adopted a Medical Reimbursement Plan and a Diagnostic Medical Reimbursement Plan. The Operating Agreement of Robucci LLC designated Robucci P.C. as manager but it was not clear whether it was signed. Dr. Robucci had a limited understanding of the need for the entities formed and the agreements and other documents drafted by Mr. Carson.

Robucci LLC and Westsphere had bank accounts, while Robucci P.C. did not. Dr. Robucci did not have an employment agreement with any of those three entities, nor did any of them have employees during the years in issue. Neither Robucci P.C. nor Westsphere paid a salary to Dr. Robucci or to anyone else during those years. Dr. Robucci did not keep records of any time he might have spent working for Westsphere. Although Robucci LLC deducted "management fees" for each of the years in issue ($31,475, $25,500, and $38,385 for 2002, 2003, and 2004, respectively), its returns and bank records do not specify to whom they were paid or for what services. Dr. Robucci was aware that Westsphere charged management fees to Robucci LLC but he did not know the nature of those charges except that they related to non-patient care services.

Robucci LLC and the corporations used the same business address but there was no written lease agreement between Robucci LLC and either of the corporations.

The corporations did not (1) have separate Web sites or telephone listings, (2) pay rent to Dr. Robucci or Robucci LLC, (3) have customers other than Robucci LLC or contracts with any other third parties, or (4) advertise. Westsphere did not have separate dedicated space in Dr. Robucci's office. Dr. Robucci continued to bill Medicare and Medicaid (a relatively small portion of his practice) as an individual practitioner and not through Robucci LLC.

During the years in issue, Robucci LLC was a calendar year taxpayer and the corporations reported on the basis of fiscal years ending November 30.

Dr. Robucci's Self-Employment (SECA) Taxes

Dr. Robucci's 2002, 2003, and 2004 Forms 1040, U.S. Individual Income Tax Return, show the following distributions to him of "passive" and "nonpassive" income from Robucci LLC:

Year	Passive Income	Nonpassive Income
2002	$48,153	$5,665
2003	57,446	6,851
2004	95,143[1]	11,193

Dr. Robucci's 2004 return reported this $95,143 amount as nonpassive income on Schedule E, although the 2004 Schedule K-1 from Robucci LLC in connection with his 85percent partnership interest lists $95,143 as the distribution attributable to that (passive) interest, and Dr. Robucci's 2004 Schedule SE, Self-Employment Tax, included only $11,193 as net earnings from self-employment.

Dr. Robucci's Schedule SE filed for each of those years lists the 10% "general partner: nonpassive income as gross earnings from self-employment.

The Tax Court noted that the Supreme Court in Gregory v. Helvering, 293 U.S. 465, 469 (1935) stated: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Directly after that statement, however, the Court added the admonition: "But the question for determination is whether what was done, apart from tax motive, was the thing which the statute intended." Id.

In Chisholm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935), Judge Learned Hand elaborated upon the Supreme Court's admonition in Gregory, stating: "The question always is whether the transaction under scrutiny is in fact what it appears to be in form".

The issue in these cases is whether the corporations, Robucci P.C. and Westsphere, are entitled to respect as viable business corporations or whether, as in Judge Hand's description of the facts in Gregory, the incorporator's "intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court * * * [understands] that word." Id. In other words, were Robucci P.C. and Westsphere corporations in fact as well as in form; i.e., were they "the thing which the statute intended" when referring to corporations?

A corporation will be recognized as a separate taxable entity if (1) the purpose for its formation is the equivalent of business activity or (2) the incorporation is followed by the carrying on of a business by the corporation. Moline Props., Inc. v. Commissioner, 319 U.S. 436, 438-439 (1943); Achiro v. Commissioner, 77 T.C. 881, 901 (1981).[6] If neither of those requirements is satisfied, the corporation will be disregarded for Federal tax purposes, and all of its income will be attributed to the true earner. Shaw Constr. Co. v. Commissioner, 35 T.C. 1102, 1114-1117 (1961), affd. 323 F.2d 316 (9th Cir. 1963); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597-607 (1959).

The Tax Court held that it need not decide the burden of proof issue under section 7491(a) because a preponderance of the evidence supports the resolution of that issue. Therefore, resolution of that issue does not depend on which party bears the burden of proof. See, e.g., Estate of Bongard v. Commissioner, 124 T.C. 95, 111 (2005).

Business Purpose Of The Structure**.**

The taxpayers argue that as "managing member" of Robucci LLC, Robucci P.C. "performed oversight and management" services and that Westsphere was established to (1) "provide oversight, and to manage certain overheads and indirect expenses, including employee benefits such as health insurance", (2) "track business expenses and overheads", and (3) create a "group" for group sickness and accident insurance coverage under Colorado law. Taxpayers also argue that the formation of a multimember LLC, including a corporate member, afforded Dr. Robucci superior protection, under Colorado law, against personal liability for acts of Robucci LLC, and that Robucci P.C.'s interest in Robucci LLC was necessary to accomplish that goal.

The IRS argues that (1) the corporations "were created solely for the purpose of reducing . . . [Dr. Robucci's] tax liability" and to help him "avoid income and self-employment taxes"; (2) taxpayers "did not offer any credible explanation of the business purpose for forming the corporations"; and (3) taxpayers "did not demonstrate that either corporation engaged in any business activity after it was formed." The court agreed with the IRS.

Taxpayers state two reasons for the formation of Robucci P.C.: (1) Its role as the "managing member" of Robucci LLC, a role not reflected in Robucci P.C.'s articles of incorporation, which state that its "sole purpose" is to practice medicine "through persons licensed to practice medicine" and (2) the superior protection against personal liability that would be afforded to Dr. Robucci by the formation of a multimember LLC.

Assuming that Robucci P.C. was properly organized under Colorado law, that fact does not mean that it performed any function that would warrant its recognition as an entity for Federal tax purposes. E.g., Noonan v. Commissioner, 52 T.C. 907, 909 (1969), affd. 451 F.2d 992 (9th Cir. 1971). Although Robucci P.C. may have been a party to an "operating agreement" with Robucci LLC, whereby it was appointed Robucci LLC's "manager," there is no evidence that Robucci P.C. performed any management or other services for Robucci LLC. Robucci P.C. had no assets (other than its interest in Robucci LLC) or employees, it had no service contract with Robucci LLC, and it paid no salary to Dr. Robucci or anyone else during the years in issue. In fact, Robucci P.C. was not intended to perform management services or other business activities. Mr. Carson's handwritten note states: "We need P.C. to be a partner in LLC only; Westsphere is the mgmt. corp. P.C. does nada [nothing]."

In support of the second reason of limiting Dr. Robucci's liability, taxpayers cite In re Albright, 291 Bankr. 538 (Bankr. D. Colo. 2003), in which the court permitted the trustee in bankruptcy to liquidate all of the property of a single-member LLC on behalf of creditors. The Tax Court held that Taxpayers' reliance upon Albright is misplaced. That case does not involve a creditor's right to hold the sole member of a single-member LLC personally liable for the LLC's debts. Rather, it holds that all of the LLC's assets are available to satisfy the claims of the sole member's creditors (and not that the sole member's assets are available to the LLC's creditors). The trustee in Albright did not attempt to pierce the "corporate" veil to reach the member's personal assets to satisfy the LLC's debts

The court concluded that Robucci P.C. was not formed for a purpose that "is the equivalent of a business activity" within the meaning of Moline Props., Inc. v. Commissioner, 319 U.S. at 439.

Westsphere Management Corporation

Taxpayers list three purposes for the organization of Westsphere: management, the tracking of overhead and indirect expenses, and to form a group for insurance purposes. However, the evidence refutes the notion that those alleged purposes constituted bona fide nontax purposes. Although, Westsphere had a checking account, like Robucci P.C., it had no employment agreement with Dr. Robucci and no employees. Nor did it perform any management or other services for Robucci LLC in the person of Dr. Robucci.

Rather, Dr. Robucci continued to conduct his practice as he always had, including the retention of Ms. Williams as his billing assistant. Both before and after the formation of Robucci LLC, Ms. Williams was the billing assistant for Dr. Robucci's practice. Although she received instructions from Dr. Robucci in letters with a letterhead "Tony L. Robucci, M.D., A Professional L.L.C.," she considered herself to be the employee of Dr. Robucci.

The only activity allegedly attributable to Westsphere during the audit years was its reimbursement of various expenses incurred by Dr. Robucci and Robucci LLC pursuant to the various plans. Dr. Robucci testified that that activity consisted of electronic transfers of funds between bank accounts. Thus, Dr. Robucci continued, as in prior years, to pay the expenses of his practice, but allegedly out of Robucci LLC's bank account. Westsphere's only alleged "service" was to reimburse those expenses by electronic transfers of funds from its account to Robucci LLC's account. The bank account statements in the record provide scant evidence that there were, in fact, regular interaccount transfers from Westsphere to Robucci LLC. For example, Westsphere's bank statement dated January 23, 2003, shows debits of $5,097.60 and $1,114.84 for a 2002 Medical Expenses Reimbursement and a Health Insurance Premium Reimbursement, but the absence of corresponding credits to Robucci LLC's account on the same date or thereafter indicates that the transfer of funds was to Dr. Robucci's personal account. In fact, the bank statements contained no correlation between debits to Westsphere's bank account and credits to Robucci LLC's bank account. Any interaccount transfers, to the extent they occurred, were the equivalent of taking money from one pocket and putting it into another because Dr. Robucci controlled both entities.

Such a procedure hardly qualifies as a "business activity" under Moline Props., Inc. v. Commissioner, supra at 439.

Taxpayers also argue that the organization of Westsphere was essential in order to create a "group" eligible for group sickness and accident insurance. Whatever the merits of taxpayers' concerns in that regard, it is not clear how the formation of Westsphere alleviated those concerns. The "groups" to be afforded coverage are "groups of persons," generally, under policies issued to an employer for the benefit of the employees, which include officers, managers, and other employees of the employer. See Colo. Rev. Stat. sec. 10-16214(1)(a). It is difficult to see how the organization of Westsphere, which neither is an employee of Robucci LLC nor has employees of its own, could serve to qualify for small group or small employer health insurance. More importantly, there is no evidence that Robucci LLC made any effort to obtain group health insurance for its sole operative, Dr. Robucci. Dr. Robucci or Robucci LLC continued to pay premiums for health insurance but it is not clear that the policy differed from the one Dr. Robucci had as a sole proprietor.

Taxpayers have not persuaded us that Westsphere was organized for a purpose that "is the equivalent of a business activity" under Moline Props., Inc. v. Commissioner, supra at 439.

Robucci P.C. and Westsphere were hollow corporate shells. The court ruled that neither carried on a business after incorporation, the second alternative prong for corporate viability under Moline Properties. Because Robucci P.C. and Westsphere served no significant purpose or function other than tax avoidance, they should be disregarded. What we said in Aldon Homes, Inc. v. Commissioner, 33 T.C. at 598, in disregarding 16 so-called alphabet corporations is equally applicable to this case:

The alleged business purposes impressed us simply as a lawyer's marshaling of possible business reasons that might conceivably have motivated the adoption of the forms here employed but which in fact played no part whatever in the utilization of the [structure employed]

Thus, Robucci LLC was a single-member LLC. The result is that Dr. Robucci is a sole proprietor for Federal tax purposes, which was his status before the formation of Robucci LLC and the corporations. It follows, and we hold, that the net income arising from his psychiatric practice during the years in issue, including any amounts paid to Robucci P.C. and Westsphere, was self-employment income of Dr. Robucci subject to self-employment tax under section 1401.

Imposition Of The 6662 Accuracy-Related Penalty

The IRS has established that Dr. Robucci's understatements of income tax for the years in issue are substantial as they exceed both 10 percent of the correct tax and $5,000. Therefore, there was no need to determine whether Dr. Robucci was negligent under section 6662(b)(1).

Section 6664(c)(1) provides that the penalty shall not be imposed with respect to any portion of an underpayment if a taxpayer shows that there was reasonable cause for, and that the taxpayer acted in good faith with respect to, that portion. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. Reg. § 1.6664-4(b)(1).

Under section 7491(c), the IRS bears the burden of production, but not the overall burden of proof, with respect to Dr. Robucci's liability for the section 6662(a) penalty. By demonstrating that Dr. Robucci's understatements of income tax exceed the thresholds for a finding of "substantial understatement of income tax" under section 6662, the IRS has satisfied his burden of production.

<u>CPA/Attorney As Promoter</u>. The IRS argues that there was no reasonable cause for the positions taken by Dr. Robucci and that he did not act in good faith. In the IRS's view, "[p]etitioner should have requested a second opinion after getting advice that was clearly too good to be true". the IRS views Mr. Carson as "the promoter of the arrangement, who earned substantial fees for incorporating the various sham entities and preparing the tax returns at issue." Taxpayers deny that Mr. Carson was a promoter and argues that, in the light of Mr. Carson's status as an independent, experienced C.P.A., Dr. Robucci was under no obligation to obtain a second opinion before he could reasonably rely on Mr. Carson's advice.

<u>Too Good To Be True</u>. The court held that even if we were to agree with petitioner that Mr. Carson was not a promoter, we agree with the IRS that the tax result afforded by implementing Mr. Carson's suggestions, i.e., the dramatic reduction in Dr. Robucci's self-employment taxes, was "too good to be true." See, e.g., <u>Neonatology Associate, P.A. v. Commissioner</u>, 299 F.3d at 234 ("When * * * a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril."); <u>McCrary v. Commissioner</u>, 92 T.C. 827, 850 (1989) (stating that no reasonable person should have trusted the tax scheme in question to work).

<u>Carson's Structure Might Have Worked If Implemented Properly</u>.

Somewhat contrary to its statement that the structure led to a tax result that was too good to be true, the court stated that Mr. Carson's goal of directing some of Dr. Robucci's income to a third-party corporate management service provider and bifurcating Dr. Robucci's interest in Robucci LLC so that he would be separately compensated for the use of his intangibles was not unreasonable. On the contrary, had it been more carefully implemented, it well might have been realized, at least in part. In footnote 11, the court noted that although it is the IRS's position that profit distributions to service-providing members of a multimember, professional service LLC are never excepted from net earnings from self-employment by § 1402(a)(13), which excepts distributions to a limited partner other than sec. 707(c) guaranteed payments for services rendered, the Treasury has yet to issue definitive guidance with respect to that issue.

Although Robucci P.C. and Westsphere were properly formed under Colorado law to carry out legitimate corporate functions, the fact that they were nothing more than empty shells, devoid of property (Westsphere did have a bank account), personnel, or actual day-to-day activities, i.e., of substance, should have sent warning signals to Dr. Robucci that those corporations were not effecting any meaningful change in the prior conduct of his medical practice. There were also no contracts between the entities or with Dr. Robucci and his PC. Additionally, the LLC paid Dr. Robucci for his “active services, not his PC, which did not have any activity or even a bank account.

While Dr. Robucci may have had some vague notion that he was acting on behalf of Westsphere when performing services other than actual patient care, there is little or no evidence as to the precise nature of those services, the time Dr. Robucci may have spent performing them, or their value. In short, there is no support for any charge from Westsphere to Robucci LLC for such services or for the claim that Dr. Robucci was wearing a Westsphere hat when he performed them.

For Dr. Robucci, aside from signing a raft of documents and shifting some money between two new bank accounts, it was business as usual. Although he might have been justified in relying upon Mr. Carson's expert valuation of his intangibles as the basis for the 85-10 split between his limited and general partnership interests in Robucci LLC, the lack of any formal transfer of those intangibles to Robucci LLC should have been cause for concern.

Under those circumstances, Dr. Robucci, even though he was not a tax professional, should have questioned the efficacy of the arrangement that purported to minimize his taxes while effecting virtually no change in the conduct of his medical practice. He should have sought a second opinion. By not doing so, Dr. Robucci failed to exercise the ordinary business care and prudence required of him under the circumstances. See <u>United States v. Boyle</u>, 469 U.S. at 251; <u>Haywood Lumber & Mining Co. v. Commissioner</u>, 178 F.2d 769, 770771 (2d Cir. 1950), modifying 12 T.C. 735 (1949), which involve circumstances exemplifying the exercise of ordinary business care and prudence.

K. <u>Conclusion</u>.

The C corporation double tax would not be a major factor if the C corporation owners do not plan to pay dividends and if it is unlikely that the business will be sold or if the sale would be a sale of stock and not assets. Although the C corporation owners (unlike S corporation/partnership owners) do not get a basis step-up for earnings retained at the entity level, the low initial corporate income tax rate and the preferred capital gains tax rate would still likely combine to provide a lower overall present value effective tax rate for the purchase price attributable to these retained earnings if the owners sold their business in a stock sale. Nevertheless, most purchasers will want to “buy assets” in order to achieve a step-up in basis for the intangible assets represented by the portion of the purchase price in excess of the corporation’s internal basis in its assets, so that those amounts can be depreciated or amortized for tax purposes, and to avoid inheriting the sold entity’s liabilities. In general, this means a sale of assets at the entity level, either an actual sale of assets or a deemed sale of assets via a section 338(h)(10) election for an S corporation. The 34% initial tax and the 20% tax on liquidation combine for an effective rate of around 48% on $500,000 of proceeds. This compares with only a 20% single tax rate (plus applicable Medicare tax) applicable in the S corporation and partnership/sole proprietorship sale scenarios. This double-tax can be mitigated by non-compete payments directly to the individual owners, consulting and compensation payments, and sale of personal goodwill, where it exists. However, the marginal tax rate of around 46% will apply to ordinary income payments for someone in the highest bracket subject to deduction phaseouts. Additionally social security and Medicare taxes would apply to any consulting or compensation payments.

II. **NON-TAX CONSIDERATIONS**.

In recent years, the number of business entity forms available has doubled, adding limited liability companies ("LLCs"), limited liability partnerships ("LLPs") and limited liability limited partnerships ("LLLPs"), to general partnerships, limited partnerships and corporations.

The factors that differentiate these various types of business entities are:

- the extent to which the entity shields its owners from personal liability for the debts or obligations of the entity;
- the management structure of the organization and the extent to which management may be centralized among a group consisting of less than all the owners; and
- the income tax treatment of the organization and its owners.

As a result of changes in the statutes governing certain of these entities adding flexibility to their structure, business planners now consider many of the forms of business organization to be interchangeable except for the sole proprietorship and general partnership. Nonetheless, numerous issues exist as to the liability protection in operations outside the state of formation and operational income tax issues.

Terminology For Uniform Partnership Acts.

The correct name for the revised uniform partnership act is the Uniform Partnership Act (1997). In 1994, the "Revised" was dropped. Nonetheless, "Revised" and RUPA have become firmly fixed in common parlance as the name of the act.

The Uniform Limited Partnership Act (2001) is the successor to the Revised Uniform Limited Partnership Act (1976). The Uniform Limited Partnership Act (1976) is referred to as ULPA. With its 1985 Amendments, it was commonly referred to as the Revised Uniform Limited Partnership Act or RULPA. The uniform act approved in 2001 was through the drafting process called ReRULPA, the revision of RULPA, and that unofficial acronym is often used.

A. Sole Proprietorship.

A sole proprietor is a business owned by one individual that does not have limited liability. For income tax purposes, its activities are reflected on Schedule C of the personal form 1040 income tax return. The owner is personally liable for the liabilities of the proprietorship.

B. General Partnership.

The definition of a partnership is "an association of two or more persons to carry on, as co-owners, a business for profit." The basic form of partnership is a general partnership ("GP"). No formal action, state filing, or written agreement is needed to form a general partnership. As a result, any

business (where profits are shared) involving two or more owners will be a general partnership unless the participants make a different agreement.
In a general partnership (i) each partner has an equal right to participate in management, (ii) each partner has the authority to make commitments or enter into binding agreements on behalf of the partnership, (iii) the death or withdrawal of one of the partners results in the dissolution of the partnership for income tax purposes, and (iv) a general partnership does not provide a liability shield for its partners, because each partner has complete joint and several liability for all debts and obligations of the partnership.

Under versions of the Uniform Partnership Act in many states, a general partnership can be created in which the first three characteristics described above are eliminated and are replaced with the corporate characteristics of centralized management and continuity of life. In other words, it is possible to have a general partnership in which certain partners do not have the ability to participate in management decisions relating to the business of the partnership or to enter into binding agreements on behalf of the partnership. It is also possible to structure a general partnership in such a way that the death or withdrawal of one of the partners does not cause the partnership to be dissolved.

The most significant disadvantage of a general partnership is that partners have joint and several personal liability for partnership debts and obligations.

C. Corporation.

Corporations are the most formal type of business entity. They provide a liability shield for their shareholders, have a centralized management group consisting of a board of directors elected by the shareholders (except for statutory close corporations managed by their shareholders), and they have perpetual existence. Corporations are the preferred form of business entity for organizations that have a large and diverse ownership group and for organizations that intend to make a public offering of their securities. Statutory close corporations are used when the owners want to vote on matters on which directors vote by number of shares rather than 1-director, 1-vote.

Unless a corporation and its shareholders make an affirmative election under Subchapter S of the Internal Revenue Code, the corporate entity is separated from its owners for tax purposes and is responsible for payment of its own income tax. All of the other forms of business organization mentioned above are generally intended to be pass-through entities for tax purposes, meaning that the entity itself does not pay income tax. Instead, the owners are responsible for payment of income taxes on their proportionate share of the entities income.

Professional corporations or associations are permitted for professionals in all states and have their own somewhat unique rules. Only licensed professionals can be owners. Where special statutory rules do not apply, the regular state corporation statute applies.
Professional corporations can be “C” or “S” corporations for tax purposes, although 13 states do not recognize S corporations.

Additionally, in most states, there is a “corporate practice” doctrine in the statute or by case law that prevents the use of a general business corporation by a professional practice. Professionals subject to a state prohibition on the corporate practice of their profession may be legally precluded from operating their professional medical practices through LPs (or LLLPs) and can only do so through GPs (or LLPs) if all partners thereof are either duly licensed individuals or PAs or PLLCs legally authorized to render the same professional medical services as the GPs are organized to provide.

Ancillary medical ventures (specialty hospitals, ambulatory surgery centers, imaging centers, etc) principally formed to offer the technical component of medical services and not any professional services cannot qualify for PA or PLLC status because they are not rendering a professional service, even if all shareholders or members thereof are duly licensed medical professionals legally authorized to offer such ancillary (technical) medical services as part of their professional medical practices. An exceptions to the general rule that PAs or PLLCs are not available for the operation of ancillary medical ventures may include the operation of diagnostic imaging facilities by duly licensed radiologists who offer the technical component of diagnostic imaging services through a PA or PLLC, as part of and ancillary to their provision of their professional interpretative services.

State nonprofit corporations are in a few cases used to run businesses that are taxed as for profit corporations for federal and state purposes.

D. Limited Liability Company.

In most states, LLCs are the most popular form of organization for new business entities because of the liability protection they provide to all owners and the flexibility they afford in defining the business relationship between the parties. An LLC is formed by filing articles of organization with the secretary of state. After filing the articles of organization, the basic business arrangement between the owners of the LLC (who are referred as to “members”) is set forth in a separate agreement usually called an operating agreement. The state statute provides default operating rules, most of which can be varied in the operating agreement, which is a contract among the members of the LLC. The LLC itself should also adopt the operating agreement.

One popular form of LLC is the single member entity. Both the IRS and the state law authorize the creation of a single member LLC. Such an entity is, in many ways, the equivalent of a sole proprietorship with limited liability protection or a division of a corporation or other entity that owns the SMLLC.

Another subset of LLC available in a few states is the series LLC. There are many uncertainties about its operation.

E. Limited Liability Partnership.

A limited liability partnership (“LLP”) is a general partnership that registers with the secretary of state as an LLP. The effect of registration is to limit the vicarious liability of each of the partners. The LLP arose in the early 1990s as a response to the malpractice joint and several liability sought to be imposed upon attorneys and accountants who were partners in general partnerships for the failures of the savings and loans associations, including partners who had no involvement with that work. The original statutes (Texas was the first) were partial shield statutes, providing limited liability against tort liabilities for members not involved in the work but not contract liabilities. Most states LLP statutes now provide protection from both types of liability except for the partners involved in the work. The LLP is not itself a separate and distinct form of business organization. Rather, the LLP is a general partnership that files with the state to avoid the traditional rule of joint liability for claims arising in the course of the partnership's business.

Partners in an LLP in all states are liable for debts or obligations of the organization that arise as a result of their own negligence, wrongful acts, or improper conduct. In many states, this limited liability also extends to contract liabilities (these are called "full shield" states). Partial shield statutes include Ky. REV. STAT. ANN. § 362.220(2) (2002) prior to its revision; and TENN. CODE ANN. § 61-1-306 (2002); W. VA. CODE § 47B-3-6(c).

All general partnerships should consider whether registration as an LLP is appropriate if permitted by state law because the process of registration is simple. The form filed is a simple one-page form, and the partnership must change its name to include the words "Limited Liability Partnership" or the abbreviation "LLP." Some states, such as New York and California, allow only certain professional service firms to elect LLP status, although most states allow any type of business general partnership to elect limited liability status.

At the time of registration, modification of provisions of the written partnership agreement dealing with indemnification and with the obligations of partners to make additional contributions to the partnership should be made to make those provisions consistent with limited liability. For example, if a partnership agreement has provisions that require a partner with a negative partnership capital account to make up such a deficit, such a provision in your LLP's operating agreement could open a back door of liability for partners, defeating the goal of having a limited liability legal entity, although the laws in some states now protect an LLP against such an oversight.

F. Limited Partnership.

A limited partnership ("LP") is a partnership formed by two or more persons, in which at least one of the partners is a general partner and at least one of the partners is a limited partner. Generally, the general partners in a limited partnership have the same rights and responsibilities as general partners in a general partnership. As a result of amendments to the Uniform Partnership Act, it is now possible in many states to have a limited partnership in which certain of the general partners do not have the ability to participate in management decisions relating to the business of the partnership or to enter into binding agreements on behalf of the partnership. It is also possible to structure a limited partnership in such a way that the death or withdrawal of one of the general partners does not cause the partnership to be dissolved.

Limited partners are protected from liability for the debts and obligations of the partnership as long as they do not participate in control of the business of the partnership. Likewise, under current law in many states, limited partners may lose their limited liability protection if they participate in management in a manner that is inconsistent with their limited partner status. Under the Uniform Limited Partnership Act (2001), a limited partner is no longer statutorily constrained from participating in the management of the organization.

Family limited partnerships have become a popular vehicle to be used for estate planning and asset protection planning due to liability protection for the limited partners and ability to obtain discounts in the value of the LP's assets for estate and gift tax purposes, as well as to pay unearned income to lower bracket partners.

The advantage of a limited partnership, from the standpoint of a limited partner, is the limited liability protection that the entity affords. The disadvantage is that in order to obtain the limited liability protection, limited partners must refrain from participating in control of the business except in those states where it is permitted. The advantages and disadvantages from the standpoint of the general partner are that the general partner has sole responsibility for management of the partnership business and must accept personal liability for partnership debts and obligations. In situations in which a limited partnership seems to be the appropriate form of business organization but the prospective general partner(s) are unwilling to accept personal liability for partnership debts and obligations, the solution may be a limited liability limited partnership or to use a limited liability entity as the general partner(s).

G. Limited Liability Limited Partnership.

1. General.

A limited liability limited partnership ("LLLP") is a limited partnership that registers with the secretary of state as an LLLP, where permitted by statute. The effect of registration is to limit the vicarious liability of the general partners in the same fashion that registration as an LLP limits the liability of the general partners of a general partnership.

The earliest LLLPs were formed under both RULPA and UPA by having a RULPA limited partnership elect LLP status. Subsequently, certain RULPA statutes were amended to provide for the election of LLLP status by the limited partnership. LLLP status was made an elective status under ReRULPA.

Certain LLLP elections take the form of the limited partnership electing to be a limited liability partnership (for example, Delaware) while in other states the election is made in the certificate of limited partnership (Florida, Hawaii and Kentucky). Most states require that an LLLP identify itself in its name, but those requirements are not universal.

States permitting LLLPs include Alaska, Arizona, Arkansas, Colorado, Delaware, Florida, Georgia, Hawaii, Idaho, Iowa, Kentucky, Maryland, Minnesota, Missouri, Nevada, North Carolina, North Dakota, Pennsylvania, South Dakota, Texas, and Virginia.

The factors to consider in determining whether registration is appropriate include the impact which registration may have on the perceptions of the limited partners concerning the proper role of the general partners, and in partnerships in which there is more than one general partner, the interrelationship between the general partners with respect to their willingness and ability to contribute additional capital to the partnership when considered necessary for the furtherance of the partnership business.

2. Professional Firms.

The advantage of a limitation on personal liability co-existing with favorable pass-through tax treatment for unincorporated entities has encouraged many professional services firms to adopt the

LLP or LLC model. Which one was chosen often depended on state rules.

For example, California prohibits law, accounting, and other firms requiring a license from operating in LLC form. California law firms and multistate law firms having offices in California have embraced LLP status. Some firms operate in professional corporation form, as either S or C corporations, with the attendant applicable tax consequences to the corporations and shareholders.)

With a change in Illinois in July 2003, lawyers are now able to practice in LLPs in every state. The rules applicable to, and cost of, registration vary from state to state, and in some states the liability shield afforded LLPs may not be total. The rules applicable to other professionals also have become more flexible over recent years as laws and regulations have been changed to accommodate practice by LLCs and LLPs. Additionally, there are many domestic limited partnerships engaged in professional and business services.

(a) Practical reasons for—and against—LLLPs.

A potential advantage of operating as an LLLP (compared with LLCs) is that the law involving the rights and relationships of general and limited partners is fairly well settled, and the general partner of the LLLP may obtain the same liability shield provided to LLC member-managers. The limited partners, for example, may require the general partner of the LLLP to have the high duties of loyalty and other fiduciary duties owed by general partners in a traditional state law limited partnership.

There are also disadvantages of operating as an LLLP rather than as an LLC:

(1) Not all states recognize LLLPs, and fewer have authorized practice of licensed professions in LLLPs. Additionally, the general partner of the LLLP may be personally liable for LLLP liabilities of the LLLP arising in non-LLLP states.

(2) The general partner may have fiduciary duties owing to the limited partners as a matter of state partnership law that are not applicable to member-managers of LLCs, and under ULPA 2001 the limited partners do not have fiduciary duties, thereby distorting the duty structure within the partnership from that generally expected in a general partnership or LLP, whereby each partner owes similar duties to his or her partners and the partnership.

(3) The bulk of the management of the LLLP must be done by or under the supervision of a general partner whereas LLCs permit non-member managers, although this arrangement would be unavailable for professional service firms whose managers must be licensed.

(4) There is also the possible need to change the firm's name when one of its general partners withdraws or becomes a limited partner. Some states' versions of the ULPA (Texas) provide that a limited partnership may not include in its name the name of the limited partner unless that name is also the name of a general partner. Since an LLLP is a limited partnership, presumably the firm must change its name to delete the name of a general partner when he or she become a limited partner. This generally would not be a problem if the firm operated as an LLP, LLC, or other limited liability entity.

The use of LLLPs by professional service firms raises the question of whether use of the LLLP is legal and ethical. This a question not only of state statue but the licensing rules. In the case of law firms, even if otherwise so permitted, would that practice be unethical in light of ABA and state bar association opinions?

(b) Is LLLP Legal?

As a matter of state statute, LLLPs, where permitted, are organized and operating under the limited partnership acts. Under the statute, LLPs, where permitted, are permitted to operate all types of trades and businesses, although many limited partnership acts often proscribe engaging in certain activities such as banking and insurance.

In contrast, state rules generally permit professionals to practice in general partnership form and specified forms of limited liability entities, such as professional corporations, LLPs (under the general partnership act), and LLCs.

Delaware and Pennsylvania explicitly approve of law practice in limited partnership form (Del. S.Ct. Rule 67(a)(iii); Pa. S.Ct. Rule 5.4(d) and Comment (5)). See Donn, "Limited Liability Entities for Law Firms—Ten Years Later," 7 *J. Passthrough Entities,* July-August 2004, page 19. Indeed, one might conclude that when the supreme court rules of a state explicitly approve of professional corporations, LLCs, and LLPs by name, any other type of practice, such as business corporations (unless the state as no corporate practice prohibition by statute or case law), trusts, limited partnerships, and LLLPs may not be permissible, even if such entities can be validly formed under state statutes.

Connecticut's bar association has opined that limited partnerships formed under the ULPA are permissible forms of organization. Conn. Bar Assn. Formal Opinion No. 43 (1994). New Mexico and Pennsylvania permit lawyers to practice law as members or owners of "any limited liability entity." In those states, since the state court rules permit limited liability entity practice, this would logically have to include limited partnerships and LLLPs. See Pa. S.Ct. Rule 5.4(d) and Comment (5); Rule 24-107 NMRA of the Rules Governing the New Mexico Bar (effective 3/28/05).

Even if a law firm is formed and successfully registers as an LLLP in its home state, there remains the question of whether it can validly operate as an LLLP in other jurisdictions that do not explicitly recognize the LLLP form for law practice. Similar questions as to multistate law practice by LLCs were faced when LLCs first gained popularity.

(c) Is LLLP Ethical?

It is now. Over forty years ago, in the ABA's Committee on Ethics and Professional Responsibility informally opined that law practice could *not* be conducted in limited partnership format.[3] However, ABA Formal Opinion 96-401 (8/2/96) issued by the ABA's Ethics Committee reversed its 1965 position, and concluded that the Model Rules of Professional Conduct permit lawyers to practice in an LLP or LLLP if the applicable law provides that the lawyer rendering legal services remains personally liable to the client, the requirements of the law of the relevant jurisdiction are met, and the form of business organization is accurately described by the lawyers in their communications. The ABA Formal Opinion makes no reference to the Committee's prior informal opinions to the contrary prohibiting practice in limited partnership form.

Opinion 96-401 assumes there is compliance with applicable state statutes and other controlling law, and does not purport to indicate appropriate choice of law rules involving multi-jurisdictional

[3] ABA Informal Opinion 865 (9/23/65). That opinion was based on provisions of the original Uniform Limited Partnership Act (particularly the effective prohibition on limited partners taking part in control of the partnership's business), and on restrictions on limitations of liability for personal malpractice. This was viewed as antithetical to the lawyer's duties to the client and preclude any meaningful participation with the lawyer's partners in the conduct of the firm's business. ABA Informal Opinion 1265 (2/21/73) and ABA Informal Opinion 85-1514 (4/27/85) prohibited use of a limited partnership for an impermissible division of fees among lawyers. If it is unethical to practice as a limited partnership, it would be unethical to practice in LLLP format.

law firms. The ABA Opinion states that a requirement of any ethically permissible business form for lawyers is that the lawyer rendering the legal services to the client must be personally responsible to the client. The Opinion states the understanding that all of the LLP and LLLP laws (then enacted) of the various states meet this requirement. The ABA Opinion concludes that lawyers can avail themselves of the LLP (or LLLP) business form without that constituting an agreement with a client prospectively limiting the lawyer's liability to a client for malpractice within the scope of Model Rule 1.8, because LLPs and LLLPs do not insulate a lawyer from liability for his own negligence. Rather, the limitation on vicarious liability created by LLPs and LLLPs derives solely from state law, not from an agreement between a lawyer and his client.

Notwithstanding the green light given by the ABA Opinion, law firm and other professional LLLPs and limited partnerships are rare. There are, however, LLLP service providers in Arizona, Arkansas, Colorado, Delaware, Florida, Georgia, Hawaii, Kentucky, Maryland, Massachusetts, Minnesota, Montana, Nevada, and Texas, based on an internet Google search in late 2011.

H. Other Issues.

1. Foreign State Operations.

A limited, unsettled and contradictory body of case law exists regarding how a business entity not formally recognized in a particular foreign jurisdiction will be treated in that jurisdiction. See Rutledge, "To Boldly Go Where You Have Not Been Told You May Go: LLCs, and LLLPs in Interstate Transactions," 58:1 Baylor Law Review 205-242 (2006).

There is no such issue for corporations or LLCs operating in other states. The internal affairs rule, as embodied in both common law and corporate statutes, precludes any need to undertake a conflicts of law analysis with respect to internal corporate affairs. The law of the state of incorporation governs. However, whether shareholder liability to third parties for claims incurred by the corporation falls within internal affairs is not clear.

While the law is not clear for newer types of entities as to the effect of limited liability protection in other states outside the state of formation that do not recognize the entity in question, it is likely that courts would reach the following results:

(a) A foreign limited liability entity ("LLE") doing a type of business in a state that the same domestic entity may not engage in will likely not afford its owners limited liability;
(b) A full shield LLP in a partial shield LLP jurisdiction likely will not afford its partners limited liability;
(c) A partial shield LLP operating in a full-shield jurisdiction likely will afford its partners only a partial liability shield;
(d) A LLE owner that is not listed as having liability under a state statute where it is operating (such as a state law mentioning only corporate officials but not LLC managers as being personally liable for unpaid wages) will be found liable if liable under the state of formation.
(e) A LLLP operating in a state that does not have an LLLP statute likely will not afford its general partners limited liability.

2. State Law Merger and Conversion of Entities.

Although structural distinctions between the various forms of business entity have been minimized, there are certain situations in which business owners may consider one form of entity to be desirable over another. For example, business owners may wish to transform corporations into LLCs to obtain flexibility, or to transform an LLC or other form of unincorporated business into a corporation in the expectation of making a public offering of securities. Many states have adopted special statutory provisions in order to help to facilitate these type of transformations from one form of business entity to another. Under these provisions entities can easily convert from one form of entity in the same or another state. The statute permits these transformations to be completed administratively without the need to wind up the business affairs of the converting entity and pay its obligations or distribute its assets. As a result, the transformation is not deemed to be a dissolution of the converting entity and the entity that results from the transformation is deemed to be the same entity as the converting entity. However, for income tax purposes, conversion from a "C" or "S" corporation is treated as a liquidation followed by the formation of the new entity.

3. Continuity of Life/Withdrawal/Right to Dissolve.

Corporations and, unless otherwise specified in their respective operating or limited partnership agreements, LLCs and LPs (but not GPs) exist in perpetuity and, except as may be expressly granted by the terms of an applicable shareholders, operating or limited partnership agreement to which all shareholders, members or partners are parties, no shareholder, member or partner thereof has the unilateral right or power to dissolve or terminate any such legal entity.

Unless otherwise provided in a shareholders, operating or partnership agreement to which all shareholders, members or partners are parties, under state law, neither shareholders of corporations (including PAs), members of LLCs (including PLLCs) nor limited partners of LPs have the right to withdraw from their respective corporation, LLC or LP or otherwise force, by unilateral action, a mandatory purchase of their respective interests therein.

General partners of LPs subject to ReRULPA have the right to "dissociate" (or withdraw) from their LP as a "general partner" at any time, even if prohibited by the terms of the applicable limited partnership agreement. Such dissociation does not entitle the dissociated general partner to any distributions nor will such dissociation cause or result in a dissolution of the LP unless expressly required by the applicable limited partnership agreement or unless the dissociated general partner was the sole general partner of the LP and within 90 days from the date of dissociation, all remaining limited partners do not otherwise agree to continue the business of the LP or agree to admit and cause to be admitted at least one additional general partner.

By contrast, general partners of LPs not subject to ReRULPA, are entitled by statute to be paid the "fair market value" of their interest in such LPs upon their dissociation or withdrawal therefrom, if not otherwise provided by the terms of their applicable limited partnership agreement, even if they dissociate or withdraw from their LP in violation of the terms of their LP's limited partnership agreement.

Shareholders in professional corporations, absent a buy-sell agreement, are often only entitled to be bought at their death.

4. Claims of Outside Creditors.

Unlike judgment creditors of shareholders of corporations (except PCs or PAs in some states because owners must be licensed professionals), who are generally able to foreclose on a debtor-shareholder's stock in a corporation in order to satisfy their judgments, judgment creditors of members of LLCs or partners (general or limited) of GPs or LPs are precluded from foreclosing on a debtor-member's or debtor-partner's equity interest and, instead, are limited to obtaining what is known as a "charging order" against the debtor-member's or debtor-partner's respective membership or partnership interest. If a judgment creditor of a member or partner obtains a charging order against the debtor-member's or debtor-partner's membership or partnership interest, then such creditor will only be entitled to receive whatever distributions, if any, the debtor-member or debtor-partner is otherwise entitled to receive from the LLC, GP or LP, at the time or times the debtor-member or debtor-partner would otherwise be entitled thereto, until such time such creditor's judgment (secured by such charging order) is satisfied in full.

5. State Filing Fees & Taxation.

In some cases, the use of one type of entity versus another may result in higher state filing or annual report fees or state taxes.

6. Fiduciary Duties.

There are differences in fiduciary duties and the ability to waive, limit or modify fiduciary duties between Delaware limited partnerships and Delaware LLCs. In Delaware LLCs, they may be eliminated. Outside of the Delaware context, there may be distinctions for a fiduciary duty analysis between limited partnerships and LLCs based on whether the limited partnership is organized in a jurisdiction that has not adopted RUPA. One would expect that this difference will recede as additional jurisdictions adopt RUPA. Limited partnerships have been around much longer than LLCs and have a "greater judicial track record" that might provide guidance to future courts and practitioners. However, with the development of non-corporate limited liability entities such as limited partnerships, limited liability partnerships, limited liability limited partnerships and LLCs, all designed in one form or another to insulate ownership from liabilities of the business enterprise, as a policy matter it appears there is no logical reason to distinguish among such forms of entity for fiduciary duties.

Neither RULPA nor DRULPA identifies the fiduciary duties of a general partner. Rather, to determine what fiduciary duties are owed in a limited partnership by the general partners, reference must be to the UPA or, in those jurisdictions that have adopted RUPA, to RUPA. See RULPA §404. See J. William Callison, "Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond", 1 J. Small & Emerging Bus. L. 109, 161 (1997).

Case law under the RUPA identifies the fiduciary duties of general partners:
1. A duty of loyalty, defined as a duty not to appropriate partnership opportunities, a duty not to enter into competition with a partnership and a duty not to act adversely to the partnership's interests;
2. A duty of good faith and fair dealing;
3. A duty of care; and
4. A duty to disclose material information to the partnership.

ReRULPA takes a different approach than RUPA in that the fiduciary duties of a general partner are set forth within the text and without requiring a reference to UPA or RUPA for such purposes. ReRULPA sets forth the fiduciary duties of a general partner in a limited partnership in Section 408, “General Standards of General Partner’s Conduct.”

RULPA does not provide that a limited partner has fiduciary duties to the limited partnership or to the other partners in the limited partnership. However, in appropriate circumstances, limited partners have been held to have fiduciary duties. Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duignan & Eisenberg, 216 Cal. App. 3d 1139, 265 Cal. Rptr. 330 (Ca. Ct. App. 1989). See In Re Villa West Associates, 193 B.R. 587 (D. Kan. 1996) (limited partner not liable for breach of fiduciary duty by acting to reduce liability under personal guaranty without advising other limited partners of the possibility). In Re Kids Creek Partners L.P., 212 B.R. 898 (Bankr. N.D. Ill. 1997) (limited partner not liable as fiduciary because it took no management role and did not act to interfere with or mislead other equity holders).

ReRULPA provides that a limited partner may be subject to fiduciary duties and is subject to an obligation of good faith and fair dealing.

RUPA sets forth certain statutory guidelines for limitations on fiduciary duty obligations, but does not provide that such fiduciary duties may be eliminated in their entirety.47/ Indeed, RUPA provides that the default rules of the statute that include fiduciary duties may be waived or varied with only 10 exceptions set forth in RUPA Section 103(b). Three of the 10 exceptions pertain to fiduciary duty and the duty of good faith and fair dealing. Although the duty of loyalty may not be eliminated, the partners are free to provide by agreement for the identification of specific types of activity that do not violate the duty of loyalty if not “manifestly unreasonable.” The partnership agreement may specify a mechanism for a consent by the partners after full disclosure of a specific act or transaction that might otherwise violate the fiduciary duty of loyalty. The partnership agreement may not unreasonably reduce the duty of care (which is limited by statute to grossly negligent or reckless conduct, intentional misconduct or knowing violation of law).

The non-fiduciary duty of good faith and fair dealing may be defined within the agreement but may not be manifestly unreasonable. The manifestly unreasonable test and the outer limits of specification for good faith and fair dealing are left to the courts. Of course, the partnership agreement may specify higher standards of care, loyalty and good faith. For example, partners with strong bargaining power may insist on a higher standard of care in managing the assets of the enterprise.

ULLCA’s recitation and identification of fiduciary duties is substantially similar to RUPA. Under Section 409 of ULLCA, fiduciary duties are limited only to the fiduciary duties of loyalty and care. The fiduciary duty of loyalty is limited to (a) accounting to the company and to hold as trustee any property or profit derived from the member in winding up the business of the company or derived from the use of a member of company property, including appropriation of a company opportunity, (b) refraining from dealing with the company in the conduct or winding up of the company’s business in an adverse manner, and (c) competing with the company’s business before dissolution of the company. The duty of care is limited to refraining in engaging in grossly negligent or reckless conduct, intentional misconduct or a knowing violation of law. Like RUPA, the duty of good faith and fair dealing is imposed, but not as a fiduciary duty. Like RUPA, no violation of a fiduciary duty or the duty of good faith and fair dealing will occur when the action in question furthers the member's own interest. Furthermore, as with RUPA, lending money or transacting business with the company is permitted. However, such transaction should generally be approved by the company or members either by reference to the specific transaction or by adherence to a procedure set forth in the operating agreement of the company.

There may be a difference between LLCs organized under ULLCA and limited partnerships organized under RULPA that remain bound up with UPA. Cases have held that fiduciary duties may be modified or actions otherwise a breach of a fiduciary duty may be consented to. The ULLCA provides specific statutory blessing for such matters. There appears to be little to distinguish ULLCA LLCs and limited partnerships with RUPA general partners (other than DRUPA) and, accordingly, fiduciary duty analysis would not be dispositive in considering the choice of entity between a LLC and a limited partnership.

III. **CHART COMPARING ENTITY CHARACTERISTICS**.

Comparison Chart: Regular and S Corporations, LLC, Limited Partnership (LP), Limited Liability Limited Partnership (LLLP), General Partnership (GP), and LLP

Factor	***C Corp***	***S Corp***	***LLC****	***LP & LLLP***	***GP***
Number of Owners	No restrictions	No more than 100 shareholders	No restrictions, but need at least two members to be considered a partnership for tax purposes	Must have at least one general partner and at least one limited partner and they must be at least two different partners	Must have at least two partners
Type of Owners	No restrictions	May not have shareholders other than individuals, certain trusts, estates, and certain exempt organizations (including charitable organizations and qualified retirement trusts). May not include regular S corporations, (except for 100% owned S corporation subsidiaries), or nonresident aliens as shareholders	No restrictions	No restrictions	No restrictions
Classes of Ownership Interests	Permitted	One class only, but can have differences in voting rights	Permitted	Permitted	Permitted
Liability of Owners	Limited	Limited	Limited	General partners have joint and several liability except in LLLP; limited partners have limited liability except in unusual circumstances where they participate in management or are	General partners have several liability

				professionals, where permitted (as to own conduct)	
Owner Particip ation in Manage ment	Permitted	Permitted	Permitted	Participation by limited partners generally restricted	Permitted
Organiz ation Costs	Filing fee	Filing fee	Filing fee	Filing fee	None
Format-ion require ments	File articles of incorporation with state; adopt bylaws; initial minutes of organizers or directors	Same as for regular corporation; file S election with IRS	File articles of organization with state; adopt operating agreement	File certificate of limited partnership; adopt partnership agreement	None. Partnership ma the absence of any wr agreement
Conduct of Business in Other States	Most states have foreign corporation qualification provisions	Same as for regular corporation	Most states have foreign LLC qualification provisions	Most states have foreign limited partnership qualification provisions; many do not for LLLPs	Typically no mechani qualification of foreig partnerships
Name	Must contain "corporation," "limited," "incorporated," "company," or an abbreviation thereof	Same as for regular corporation	Must contain "L.C.," or "LLC" or words Limited Company or Limited Liability Company	Must contain Limited, Limited Partnership, Ltd., L.P., or LLLP or the full words	No requirements
Interests Transfer-able As with Full Substitu-tion of Transfer-ee	Yes, subject to agreements among shareholders	Same as for regular corporation	Only if permitted by articles of organization, regulations or operating agreement; possible tax issue if freely transferable	Only if permitted by partnership agreement; possible tax issue if freely transferable	permitted by partnersl agreement
Term	Typically perpetual unless otherwise limited incorporation	Same as for regular corporation	May not exceed term specified in operating agreement	Typically limited by partnership agreement	Typically limited by p agreement
Dissolu-	No	No	Determined by	No for limited	Yes

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tion on Death, Retire-ment, Withd-rawal, etc., of Owner			operating agreement unless state law requires	partner(s); yes for general partners unless partnership agreement provides otherwise	
Level of Income Taxes	At corporate and shareholder level	At shareholder level only, except certain items can be taxed at corporate level	At member level only, if structured to be taxed as partnership	At partner level only	At partner level
Special Allocat-ions of Tax Items	Permitted if provided as stock classes	Pro rata according to stock ownership	Permitted	Permitted	Permitted
Contrib-utions on Formati on	Taxable, unless transferors meet 80% control test of §351 of IRC and adjusted basis of assets exceeds liabilities	Same as regular corporation	Nontaxable unless disguised sale or member is relieved from debt	Nontaxable unless disguised sale or partner is relieved from debt	Same as limited partn
Deduct-ibility of losses by owners	No, except upon sale/exchange of stock if §1244 applies	Yes, subject to basis limitations; corporate debt not included in basis but shareholder debt to corporation is included	Yes, subject to basis limitations; LLC debt included in basis if taxed as partnership	Same as LLC	Same as limited partn
At-Risk Limitat-ions	Applicable, if closely held or PSC	Applicable	Applicable	Applicable	Applicable
Passive Activity Limitat-ions	Applicable, if closely held or PSC	Applicable	Applicable	Applicable	Applicable
Distrib-utions	Taxable to extent of earnings and profits	Nontaxable to extent of shareholder's tax basis in stock or debt	Nontaxable to extent of member's tax basis in LLC interest	Nontaxable to extent of partner's tax basis in partnership interest	Nontaxable to extent of tax basis in partnershi

Liquida-tion	Taxable to both corporation and shareholders	Taxable at shareholder level via flow-through of corporate items	Nontaxable to extent of member's tax basis in LLC interest	Nontaxable to extent of partner's tax partner's tax interest	Nontaxable to extent o partnership basis in pa interest
"Empl-oyee" Fringe Benefits for Owners	Permitted	Not permitted if more than 2% shareholder	Not permitted	Not permitted	Not permitted
Medicare Tax on Retire-ment Plan for Owners' Contrib utions	No	No	Yes	Yes	Yes
IRC § 409A	Applies	Applies	Not applicable to 736 payments if member is "general partner"	Not applicable to 736 payments	Not applicable to 736
IRC § 1402(a)(10) – No payroll tax on retirement payments paid until death	No	No	Probably if member is "general partner" but no rulings	Yes	Yes

*Assumes LLC is a partnership for tax purposes.