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ALERT

IS AN S ELECTION FOR AN LLC SMART PLANNING OR A BAD IDEA?

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By default, a limited liability company (“LLC”) with two or more members is taxed as a partnership. It also is possible to elect to treat an LLC as an S corporation for income tax purposes. But is it a good idea? And if an S election is made, what could go wrong? As we explain below, an S election for an LLC is rarely a good idea, in part because of the many things that can go wrong. Instead, the preferred entity for use when making an S election is a state law corporation.

S Corporations

An entity treated as a corporation for income tax purposes (a “C corporation”) is subject to tax on earnings at both the corporate level and shareholder level. One exception to this double tax is when a corporation elects to be an S corporation. In that case, corporate income in general passes through the S corporation tax-free and is taxed only once at the shareholder level. The single level tax of an S corporation is typically more tax efficient than a C corporation.

However, only a qualifying “small business corporation” can make an S election. To qualify, the corporation must have 100 or fewer shareholders, each of whom must be an individual, or certain estates and trusts, and a U.S. citizen or resident alien. In addition, the corporation must have a “single class of stock,” which means that all outstanding shares must confer identical rights to

distribution and liquidation proceeds, although non-voting and voting equity is permitted.

LLCs Making S Elections

When Congress enacted the S corporation statutes, the only entity capable of making an S election was a state law corporation, and the statutes are built on that premise. For example, they routinely reference “shareholders” and “stock”, concepts which don’t exist in LLCs. In 1996, Congress enacted the “check the box” regulations which, among other things, permit an LLC to elect to be treated (for tax purposes) as a corporation, and thereafter to make an S election.

As indicated above, under the “check the box” regulations, an LLC with more than one member is by default a partnership for income tax purposes. Similar to an S corporation, partnership income generally passes through the LLC tax-free and is taxed only at the member level. Given the similarities, why would an LLC elect to be an S corporation for income tax purposes?

One reason may be payroll taxes. In general, all of the income that passes through a partnership to a partner (other than a limited partner) is self-employment income subject to payroll taxes. For an S corporation, however, it may be possible to treat a reasonable amount of earnings as wages subject to payroll taxes, and treat the remainder as pass-through S distributions (or dividends) that are not subject to payroll taxes. Another reason may

be management of the entity. State law corporations typically are governed by a board of directors and officers. Limited liability companies, on the other hand, provide for more varied and flexible forms of governance.

When an LLC elects to be treated as an S corporation, the election is solely for federal income tax purposes. Accordingly, the LLC remains a limited liability company under state law. Assuming the LLC meets all of the qualifications for a “small business corporation,” it will then be treated as an S corporation solely for federal income tax purposes. However, if it does not meet all of the required qualifications, the S election will not be valid and the LLC will be taxed as a C corporation. Without proper counsel at the time the S election is made so as to avoid this mistake, one may not realize the mistake until many years have passed, making the consequences potentially grave.

What Can Go Wrong?

Nearly all LLC agreements are drafted on the basis that the LLC will be taxed as a partnership. Partnership concepts are baked into most LLC agreements in numerous places, and most operating agreements contain references to the relevant treasury regulations that govern partnerships. For example, LLC agreements usually include partnership provisions such as capital accounts and capital account maintenance, special and regulatory allocations of income and loss, waterfall distributions, and liquidating distributions in accordance with capital account balances. None of these provisions have any place in a qualifying “small business corporation.” Unless these provisions are scrubbed from the LLC agreement, these provisions are likely to disqualify the LLC from making an S election. Moreover, state limited liability company laws may in some cases include default allocations or distributions that may potentially violate the single class of stock rule. As a result, it may not be possible to avoid S qualification issues by making an S election and simply not adopting a form of operating agreement that contains partnership tax concepts.

It is easy to make an S election for an LLC. There is a relatively simple form that is filed with the IRS (Form 2553). Filing Form 2553 not only serves to elect S status for the LLC, it also functions to elect to treat the LLC as a corporation for tax purposes. It is not, however, quite so easy to ensure that the LLC qualifies as an S corporation. Unless the LLC agreement is carefully drafted to meet the small business corporation requirements, including the single class of stock requirement, the S election is likely to inadvertently result in a C corporation.

A state law corporation, on the other hand, is structured so that it is more difficult to blow the S election. Generally, so long as there is only one class of common stock and 100 or fewer eligible shareholders, the corporation will qualify.

In our view, the consequences of inadvertently invalidating an S election by using an LLC outweigh any typical benefits of using an LLC rather than a state law corporation. The S corporation statutes were designed for state law corporations, and so there is far less risk of an inadvertently blown S election. Of course, there may be over-riding concerns in some cases, but in those cases, it is imperative to carefully review the LLC’s organic documents to ensure that the S election will be valid both at the time of election and going forward. ◆

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