LIMITED LIABILITY COMPANY TAX PLANNING

Prepared by:
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In December 2016 Gary was interviewed by California CEO Magazine and RCBNNews.org on the subject of Criminal Tax Evasion and IRS Tax Audits: Civil and Criminal Issues. This 4 part series, which has been published by Lorman Education, can be viewed below:

Criminal Tax Evasion - Part 1
Criminal Tax Evasion – Part 2
Criminal Tax Evasion – Part 3
Criminal Tax Evasion – Part 4

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Limited Liability Company Tax Planning

By Gary S. Wolfe

A Limited Liability Company (“LLC”) is taxed under US tax law as a Partnership and annually files Form 1065 Partnership tax return. The Form 1065 is for the two or more owners (known as members). The LLC is a flow-thru entity whose profits and losses flow thru to the owners. The Form 1065 is an informational tax return, which is not a taxable entity, but reports tax information.

As compared to a C or S-Corporation (also a “flow-thru” entity), the LLC, which is taxed as a partnership has the following tax advantages:

1. Owner income/loss allocations and distributions do not have to be proportional to the ownership interest held by the LLC members vs. S-Corps;

2. LLCs may annually allocate income and cash flow among the owners that best suits them vs. S-Corps;

3. LLCs allow pooling of resources and are simple tax filings;

4. Unlike a C-Corporation which has two levels of taxation (i.e. corporate level tax on profit, second tax on dividend distributions to owners) the LLC has no company level tax and only one level of taxation on profits;

5. LLCs may easily discontinue operations and liquidate;

As compared to Limited Partnerships, LLCs has numerous advantages:

1. A Limited Partnership is managed by a General Partner who has full liability for all partnership debts (unlike an LLC Manager)

2. LLCs can have one member (partnerships need two members)

3. LLC members and manager are not liable for any judgments against other owners. Creditors of any owner can only have access to distributions from the LLC (i.e. they cannot seize any underlying assets held by the LLC)

LLC taxation is a “conduit taxation” which does not pay an entity level tax (as compared to C Corporations).

The LLC is a conduit through which income, deductions and credits and other items flow thru to the members (as stated under the US partnership tax rules, see IRC Sec. 701). The LLC and its owners (members) are separate entities. They each must file separate tax returns. The LLC can choose a tax year different from the partners.

LLC owners can be individuals, trusts, estates, corporations, partnerships or other LLCs.

The initial LLC tax planning issues upon formation include: method of accounting, depreciation, whether to amortize start up costs, and choosing the tax year.

Each LLC member contributes money, property or services to the LLC. In exchange they receive a capital interest in the LLC measured by the LLC capital sharing ratio which is the LLC members percentage ownership of the initial capital.

The total capital of the LLC is equal to the net asset value of the LLC which is the value that remains after all LLC liabilities have been paid.

The profit interest is the LLC distributive share which determines the allocation of profits, losses and other tax related items to each LLC member. The LLC distributive share is proportional to the LLC member capital interest. A profits member is not an equity member and only receives a profit interest.

Special allocations which have an economic purpose (other than altering LLC member tax liabilities) are allowed for separately stated items (e.g. tax free bond interest). If the member contributed the asset they may be entitled to all the income from the asset.

Separately stated items of an LLC flow thru to the members and are ordinary income, capital gains, losses which are taxed differently. Other separately stated items include: dividend income, tax preferences, expenses that qualify for foreign tax credit, expenses that may be itemized deductions for the members, IRC 179 expenses.

Any items that are not separately stated are netted out and divided among the members according to their distributive share.

LLC Member Capital Accounts are comprised of the money, assets or services in exchange for their LLC membership interest. The LLC Member Capital Account represents the equity of each member in the LLC (percentage ownership) and is updated annually.

The distributive share of LLC income accrues to the Member Capital Account and losses are deducted from it. The total equity of a partnership is determined as follows: Assets= Liabilities + Partner Capital account. The Capital Account balance is equal to the tax basis of the LLC membership interest which is annually increased by income and decreased by losses and withdrawals.

Any property contributed by the Member increases their interest by the value of the property. If the Member had debt on the property transferred to the LLC and the LLC assumes the liability, then the value of the Property to the contributing Member is equal to the Property's FMV plus the portion of the liability that still applies to the contributing LLC Member.

If an LLC Member contributes services for a percentage of the profits then the amount of the percentage is considered ordinary taxable income in the year that the LLC Member contributed the services.

If a Member assumes an LLC liability, it is classified as a contribution of capital in the amount of the liability. If a Member contributes services to the LLC to receive an LLC profits interest in the LLC then the value of that interest is not taxable unless the income is predictable or the Member disposes of the profits interest within 2 years of acquiring it.

The Capital Account serves as a record of the Member's tax basis in the LLC. The adjustment of basis prevents double taxation.

LLC MEMBERSHIP DISTRIBUTIONS

An LLC may distribute money or property to the members which is usually not taxable. Earnings are taxed whether or not distributed. Whether earnings are retained in the LLC or distributed to the LLC members has no affect on the taxation of those earnings. Members have to pay tax on earnings whether they are distributed or not.

Earnings are distributed to each Member capital account from which distributions are charged against. Any distributions that exceed the Member basis may result in capital gain (or loss) that must be reported for the year in which they occur. If the LLC membership distribution exceeds the LLC Member tax basis in the LLC (known at the Member's "Outside Basis") then the excess will be recognized as capital gain.

LLC MEMBER BASES

The Inside Basis is the LLC Membership's tax basis in the individual asset.

The Outside Basis is the tax basis of each individual LLC member interest in the LLC.

When a member contributes property to the LLC, the LLC's basis in the property contribute is equal to its FMV. The LLC member outside basis increases only by the amount of the basis that the Member had in the contributed property.

LLC DISTRIBUTIONS

Current LLC distributions decreases the LLC member capital account without terminating it.

An LLC liquidating distribution pays the entire capital account to the LLC member eliminating the LLC member equity interest in the LLC. Generally, only losses are recognized in a liquidating distribution.

For LLC cash distributions, no gain is recognized from a distribution of cash or marketable securities that can easily be converted to cash, unless the distribution is more than the LLC member's outside basis, in which case the excess is taxable as capital gain computed as follows Capital Gain= Cash distribution minus LLC member outside basis.

LLC cash distributions may be made throughout the year but taken into account effective on the last day of the LLC tax year. To minimize capital gains on distributions that may be greater than a Member's equity, the basis is first increased by the amount of income earned during the year then it is decreased by any distributions. Any excess distribution over the Member’s basis is taxable as capital gain.

PROPERTY DISTRIBUTIONS

When property is distributed to a member, the LLC must treat it as a sale to at FMV. The Member’s capital account is decreased by the FMV of the property distributed. The LLC book gain or loss on the constructive sale is apportioned to each of the Member capital accounts. Generally there is never a taxable gain or loss either to the LLC or member for a current property distribution.

The LLC inside basis of the property carries over to become the LLC Member basis which reduces the Member outside basis by the amount of the carryover basis (i.e. carryover basis is the LLC inside basis for the property received in the distribution).

As with the cash distribution, if the FMV of the property exceeds the LLC Member outside basis in the LLC then the Member’s interest is reduced to zero. The LLC Member (who receives the property) has a basis in the distributed property equal to his outside basis in the LLC before the distribution. The property basis that remains after subtracting the outside basis is taxable as a gain.

If distributed property had a secured liability, then the Member assumes the liability which decreases their share of the LLC liabilities. Other Member’s share of LLC liability is also decreased the “deemed distribution”. If any part of the distribution is greater than a Member’s LLC outside basis then the excess is treated as a capital gain.

For liquidating distributions, gains are recognized when cash received is in excess of the Member’s outside basis. When a Member receives cash and property the cash is taxable if in excess of the outside basis, the property is not subject to immediate tax. Any gain represented by the distribution of property

Is not recognized immediately but rather reduces (not below) zero the Member’s basis. If the Member’s basis in the property is not below zero, then gain would be recognized on sale. Effectively, the tax is deferred until the Member sells the Property received and then a capital gain tax is due on the excess of the gain over the remaining Member basis. The Member's basis in the Property is computed: Member Outside basis less cash received.

Gain or loss may also be recognized by a Member who contributes Property to the LLC which Property is subsequently distributed to another Member within 7 years, in which case, the Contributing Member would recognize a gain of the FMV of the Property over the Member's original tax basis in the Property (See IRS Pub 541).

LLC TAX REPORTING

Members must pay tax on net LLC income, even if the LLC retains the income. LLC income that a Member does not withdraw increases the LLC Member outside basis. LLC distributions to a Member decreases the Member Outside Basis.

LLC Member distributions to Members are not taxed unless the distribution exceeds the Member's Adjusted Basis, in which case the excess is taxable, otherwise the distribution is considered a return of capital.

Annually the LLC files Form 1065 (Federal/US tax return; Form 568 for California) under the LLC Federal Employer ID #). The tax return is due the 15th due of the 3rd month after end of LLC tax year. A Schedule K-1 is sent to each Member confirming the Member's share of income, deduction, credit and other allocated items by the LLC. Starting in 2017, the Surface Transportation & Veterans Health Choice Improvement Act of 2015 changed the Form 1065 filing date from April 15 to March 15.