

# LIMITED LIABILITY COMPANIES: *SPECIAL TAX ISSUES*

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[Criminal Tax Evasion - Part 1](#)

[Criminal Tax Evasion – Part 2](#)

[Criminal Tax Evasion – Part 3](#)

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# Limited Liability Companies: Special Tax Issues

By Gary S. Wolfe

A Limited Liability Company (LLC) is an entity formed under state law by filing their Articles of Organization. Unlike a Partnership, none of the LLC members are personally liable for LLC debt.

For US income tax purposes an LLC may be classified as either a partnership, corporation or disregarded as an entity separate from its owner (See IRS Form 8832; Treas. Reg. 301.7701-3). A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for federal income tax purposes.

In comparison to an LLC, a Partnership is an unincorporated organization with two or more partners who carry on a trade, business, financial operation and divide its profits (losses).

Spouses who own a qualified entity can elect either Partnership tax classification or sole proprietorship (by filing Schedule C/Form 1040) listing one spouse as the sole proprietor (See IRS Publication #555: Community Property). A qualified entity is a business wholly owned by spouses as community property, the business is not treated as a corporation, no person other than one or both spouses would be considered as an owner for federal tax purposes.

Currently 9 states have community property: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin.

A Family Partnership includes family members subject to one of the following requirements:

- 1) If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own and control the Partnership interest.
- 2) If capital is not a material income-producing factor they joined together in good faith to conduct a business including sharing profits, providing capital and services.

## LLC CAPITAL INTEREST

An interest in assets that is distributable to the owner of the interest as either an LLC withdrawal or LLC liquidation.

For a gift of an LLC capital interest, if a family member receives a gift of a capital interest in which capital is a material income-producing factor, the donee's distributive share LLC income is subject to restrictions:

- 1) It must be calculated by reducing the LLC income by reasonable compensation for services that the donor renders to the LLC;
- 2) The donee's distributive share of LLC income attributable to donated capital must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

If an LLC Member interest is purchased by one family member from another family member, it is considered a gift from the seller. The FMV of the purchased share interest is considered donated capital. Family members include: spouses, ancestors and lineal descendants.

## FOREIGN LLC MEMBERS

If an LLC acquires a US Real Property Interest from a foreign person/firm the LLC may have to withhold tax on the amount it pays for the property (including cash, the FMV of other property and any assumed liability).

If an LLC has income effectively connected with a US trade or business, it must withhold tax on the income allocable to foreign LLC members.

If an LLC distributes FDAP income (fixed, determinable annual periodical income) the LLC may have to withhold tax on the foreign LLC member's distribution.

If the LLC fails to withhold it may be held liable for the tax, penalty and interest due (See: IRS Pub. #515 Withholding of Tax on Non-resident Aliens and Foreign Entities).

## LLC TERMINATION

An LLC terminates when of the following events occur:

- 1) All of its business operations are discontinued;
- 2) At least 50% of the total interest in LLC capital and profits is sold or exchanged within a 12 month period (including a sale or exchange to another LLC member)

The LLC date of termination ends the LLC tax year as of the date of the LLC termination.

Short Period tax return is filed if the LLC is terminated before the end of its tax year.

#### CONVERSION OF PARTNERSHIP INTO AN LLC DOES NOT TERMINATE THE PARTNERSHIP

The LLC can continue to use the Partnership's Taxpayer ID # as long as the LLC is classified as a partnership.

If the Partnership/LLC has recourse liabilities that become non-recourse liabilities, since the LLC members share recourse and non-recourse liabilities differently, their bases must be adjusted to reflect their new sharing ratio. If a decrease in an LLC member share of liabilities exceeds the Member's basis, they must recognize gain on the excess.

#### LLC CONSISTENT ACCOUNTING

For purposes of maintaining a consistent accounting, the LLC should use a single reasonable method for accountings for different items of contributed property (See Treas. Reg. 1.704-3)

#### LLC DISTRIBUTIONS

LLC distributions include: LLC member withdrawals (in anticipation of current year's earnings), current or prior year's earnings not needed for working capital, complete or partial liquidation of a member's interest, distribution to all LLC members in a complete liquidation of the LLC.

LLC distributions are not taken into account in determining a Member's distributive share of LLC income or loss. If LLC gain or loss is recognized by the Member it must be reported for the tax year in which the distribution is received. Money or property withdrawn by a partner in anticipation of the current year's earnings is treated as a distribution received on the last day of the LLC tax year.

## LLC DISTRIBUTION EFFECT ON MEMBER BASIS

A Member's adjusted basis in their LLC interest is decreased (but not below zero) by the Money and adjusted basis of the property distributed to the Member. Generally, an LLC does not recognize gain or loss because of Member distributions. The LLC may elect to adjust the basis of its undistributed property.

## LLC MEMBER GAIN OR LOSS ON DISTRIBUTIONS RECEIVED FROM THE LLC

Generally, an LLC Member recognizes gain or loss on an LLC distribution to the extent money or marketable securities included in the distribution exceeds the adjusted basis of the LLC Member's interest. Gain recognized is generally treated as capital gain from the sale of the LLC member interest on the date of the distribution. If property distributed is neither money or marketable securities then the LLC member does not recognize any gain until the sale or other disposition of the property.

An LLC member does not recognize a loss on an LLC distribution unless the following requirements are met:

- 1) the adjusted basis of the LLC member's interest in the LLC exceeds the distribution;
- 2) the Member's entire interest in the LLC is liquidated;
- 3) the distribution is in money, unrealized receivables or inventory items.

## DISTRIBUTION OF LLC MEMBER DEBT

If the LLC acquires a Member's debt and extinguishes the debt by distributing it to the LLC member, the member will recognize capital gain or loss to the extent the FMV of the debt differs from the basis of the debt. The



LLC member is treated as having satisfied the debt for its FMV. If the issue price of the debt exceeds its FMV when distributed, the Member may have to include the excess amount in income as cancelled debt.

## PARTNER BASIS FOR DISTRIBUTED PROPERTY

Unless there is a complete liquidation of an LLC Member interest, the basis of the property (other than money) distributed to the Member by the LLC is its adjusted basis to the LLC immediately before the distribution.

The basis of the property to the Member cannot be more than the adjusted basis of their interest in the LLC reduced by any money received in the same transaction.

In a complete liquidation of a Member interest, the Member basis in the property received is the adjusted basis of the Member's interest in the LLC reduced by any money distributed to the Member in the same transaction.

The Member Holding Period for property distributed includes the period of time the property was held by the LLC. If the property was contributed to the LLC by the member, then the period it was held by the member is also included in the holding period.

## TRANSACTION BETWEEN MEMBER AND LLC: SALE OR EXCHANGE OF PROPERTY

Special rules apply to sale or exchange of property between an LLC and Members:

- 1) Losses will not be allowed from a sale or exchange of property between an LLC and a person whose interest in the capital or profits of the LLC is more than 50%;
- 2) If the sale or exchange is between two LLCs in which the same persons own more than 50% of the capital or profits interest in the LLC, no deduction of a loss is allowed;
- 3) The Basis of each LLC Member's interest in the LLC is decreased (but not below zero) by the Member's share of the disallowed loss.



If the purchaser later sells the property, only the gain realized that is greater than the loss not allowed will be taxable. If any gain from the sale of the property is not recognized (because of the loss rule), the basis of each Member's interest in the LLC is increased by the Member's share of that gain.

In a sale or exchange between a Member and an LLC, or two LLCs, gains are treated as ordinary income if the following tests are met:

- 1) More than 50% of the capital or profits interest in the LLC is owned by the same person and
- 2) The property in the hands of the transferee immediately after the transfer is not a capital asset including: accounts receivable, inventory, stock in trade, and depreciable or real property used in a trade or business.

To determine if there is more than 50% ownership in LLC capital or profits, the following rules apply:

- 1) An interest owned by or for a corporation, partnership, LLC, estate, or trust is considered to be owned proportionately by its shareholders, members, partners or beneficiaries (the constructive owner).
- 2) An individual is considered to own an interest held by or for immediate family which includes: siblings, spouses, ancestors and lineal descendants.

## CONTRIBUTION OF PROPERTY

The Member and not the LLC recognizes gain or loss when property is contributed to the LLC in exchange for the LLC member interest. The LLC holding period includes the LLC Member Holding Period.

A contribution of money or other property to the LLC followed by a distribution of different property from the LLC to the Member is treated as a disguised sale and the Member must file IRS Form 8275 and disclose the disguised sale.

Gain is recognized when a Member contributes property to an LLC that would be treated as an investment company (.e. if over 80% of the value of its

assets is held for investments and consists of readily marketable items e.g. money, stocks et al.

For contributions by a domestic LLC to a foreign LLC in exchange for an LLC interest the domestic LLC may have to file Form 8865 if it owns at least 10% in a foreign LLC or the FMV of property contributed to the foreign LLC is greater than \$100,000.

## LLC PROPERTY CONTRIBUTIONS

A Member's basis of contributed property to the LLC is the Member's adjusted basis for the property when contribute increased by any gain recognized by the Member at the time of the contribution. The FMV of the contributed property, at the time of the contribution, may be different than the Member's adjusted basis.

If the LLC sells contributed property and recognizes gain or loss, built-in gain or loss is allocated to the contributing member. If a Member contributes property to an LLC and the LLC distributes the property within 7 years of contribution to another Member, the contributing Member must recognize gain or loss on the distribution. The recognized gain or loss is the amount the contributing Member would have recognized if the Property had been sold for its FMV when distributed. The amount is the difference between the Property's basis and its FMV at the time of contribution.

## BASIS OF MEMBER'S INTEREST IN AN LLC

The Member basis is the money plus the adjusted basis of any property the Member contributed. If the Member must recognize gain as a result of the contribution, this gain is included in the basis. Any increase of a Member's individual liabilities because of an assumption of LLC liabilities is considered a contribution of money to the LLC by the Member and increases basis.

For a gift, or inheritance, the Member basis is determined in reference to the transferor basis (see IRS Pub. #551).

## ADJUSTED BASIS

The Member basis of an interest in an LLC is increased by:

1) A Member's additional contribution to the LLC including assumption of LLC liabilities;

2) A Member's distributive share of taxable and non-taxable LLC income;

The Member basis is decreased but never below zero by the money and adjusted basis of property distributed to the Member by the LLC which include decreased share of LLC liabilities or LLC assumption of Member individual liabilities, Member distributive share of LLC losses.

The Member adjusted basis of LLC interest is determined at the end of the LLC tax year, unless there has been a sale or exchange of all or part of the Member's LLC interest in liquidation of their LLC interest then the adjusted basis is determined on the date of sale, exchange or liquidation.

## LLC LIABILITIES

A Member's basis in an LLC interest includes the Member's share of an LLC liability which liability increases the LLC basis in any of its assets, gives rise to a current deduction for the LLC, or is a non-deductible, non-capital expense of the LLC.

A Member's basis is increased if a Member's share of LLC liabilities increases which increase is treated as a contribution of money by the Member to the LLC.

The Member's basis is decreased if a Member's share of LLC liabilities decrease which is treated as a distribution of money to the Member by the LLC.

An assumption of LLC liability by a Member requires the Member is personally liable for it, the creditor knows the liability was assumed by the Member and the Creditor can demand payment from the Member, and no other Member (or related person) bears economic risk of loss on that liability immediately after assumption.

Property subject to a liability includes property contributed to an LLC by a Member, distributed by the LLC to a Member with the transferee treated as having assumed the liability to the extent it does not exceed the FMV of the property.

A Member liability is a recourse liability to the extent any Member (or related person) has an economic risk of loss for that liability defined as the Member would be obligated to make a net payment to the creditor or a contribution to the LLC with respect to the liability if the LLC were constructively liquidated.

In a constructive liquidation, the following events are treated as occurring at the same time: all LLC liabilities become payable in full, all LLC assets have a value of zero, all LLC property is disposed of by the LLC in a fully taxable transaction for no consideration except relief from liabilities for which the creditor's right to reimbursement is limited solely to one or more LLC assets. In addition all items of income, gain, loss or deduction are allocated to the LLC and the LLC liquidates.

A Member share of non-recourse liabilities is proportionate to their share of LLC profits.

#### DISPOSITION OF MEMBER INTEREST

A Member loss incurred from the abandonment or worthlessness of an LLC interest is an ordinary loss if two tests are met:

- 1) The transaction is not a sale or exchange
- 2) The Member has not received an actual or deemed distribution from the LLC. If the Member receives even a de minimis distribution from the LLC the entire loss is a capital loss (See Rev Rul 93-80).

The sale or exchange of a Member LLC interest usually results in a capital gain or loss with the exception of receipt of inventory, unrealized accounts receivable which results in ordinary income or loss.

An exchange of LLC interests does not qualify as a non-taxable exchange of like-kind property.

Liquidation of a Member LLC interest on death, payments received may have to be allocated: liquidating payments, or other payments including assumption of the LLC Member share of LLC liabilities which are treated as a distribution of money. Liquidating payments are considered a distribution. Upon the receipt of the distribution, the Member will recognize gain if any on



the money received if the distribution is more than the adjusted basis in the LLC.

The Member will recognize loss only if the distribution is in money, inventory or unrealized receivables.

Other payments made by the LLC to the Member who has retired, or their successor in interest are distributed as distributive shares of LLC property taxable as either a distributive share of LLC income or as a guaranteed payment (taxed as ordinary income). These payments are includable in income by the recipient for their tax year.

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