U.S. Taxation of U.S. Limited Liability Companies

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This is the first of a three-part series on an introduction to the cross-border tax treatment of U.S. limited liability companies. Please look for the next two parts in the July and August issues.

INTRODUCTION

For the last two decades, the limited liability company ("LLC") has been the "darling" of U.S. attorneys, accountants, and other professionals who organize entities for the purpose of business, investment, asset management, and related tax- and estate-planning purposes. The 2017 Tax Reform Act[1] has perhaps tarnished somewhat the redoubtable shine of the LLC, with the Act's introduction of a significantly reduced corporate income tax rate, which will enable corporations to compete tax-wise to a greater degree with generally tax-transparent entities like LLCs.

Nonetheless, the LLC is still attractive for business organization and related tax planning due to the remarkable flexibility it offers to U.S. advisors for organizing business and investment vehicles and for charting their tax characteristics. As entrepreneurs become ever more focused on business and investment opportunities outside the United States, the question of how U.S. LLCs fare outside the country inevitably arises. Does the flexibility afforded the LLC in the United States—especially in tax matters—also prevail in foreign countries and jurisdictions?

As this article will explain, the LLC in many cases does not enjoy the same level of flexibility it is afforded in the United States. As a result, substantial inconsistencies can develop between the tax treatment of U.S. LLCs in the United States and the treatment of U.S. LLCs in other countries and jurisdictions. These differences have to be given serious consideration when engaging in cross-border business, tax, and estate planning. Moreover, flexible structures like the LLC, which have become vehicles for so-called "hybrid" financial and business structures, have also become the target of both U.S. and international efforts to limit attempts to maximize tax savings by taking advantage of the inconsistencies between the tax and classification rules among different nations.

At the outset, let us remember that an LLC is a form of business and investment entity that can be established pursuant to the statutory law of any one of the fifty states of the United States and the District of Columbia, which permits owners ("members") to take advantage of limited personal liability, shielding them personally from the debts or obligations of the LLC—much

like the protection that is afforded to shareholders of a corporation. Unlike a corporation, an LLC does not issue stock but rather "membership interests," which are generally represented as percentages of ownership of the LLC rather than as a number of shares or units from an aggregate of available shares or units. (Note, however, that LLCs may issue ownership units if they wish to do so.) Unlike a corporation, an LLC does not have to have a board of directors or corporate officers. The members can share in the management of the LLC or can grant management responsibilities to one or more managers. An LLC can have limited duration, as set forth in the operating agreement. Finally, an LLC, by the terms of its operating agreement, can limit or restrict the otherwise free transferability of ownership interests or units.

I. U.S. TAXATION OF U.S. LLCs

Perhaps the most notable feature of an LLC organized in the United States is that it need not be taxed as a separate legal entity under U.S. federal law as well as most state laws, including those of New York and Delaware. Income allocated or distributions made to members are taxed to the members at their individual income tax rates, and members report business profits and losses on their personal income tax returns.

A. U.S. Check-the-Box Regulations

The LLC truly came into its own as a powerful tool of U.S. business and investment planning when the IRS introduced, effective Jan. 1, 1997, new entity classification rules commonly referred to as the "check-the-box" regulations. (See Treasury Regulations section 301.7701-3.) Under these rules, a relatively narrow set of U.S. and non-U.S. business entities are required to be treated as corporations—generally, in the case of non-U.S. foreign corporations, corporations that are publicly traded. (See Treasury Regulations section 301.7701-2(b).) All other business entities ("Eligible Entities") have the option to choose their U.S. federal tax classification among (1) associations (essentially, a separately taxed corporate entity), (2) partnerships (essentially, a flow-through entity), and (3) disregarded entities (essentially, a single member or owner proprietorship).

B. Tax Classification and Consequences for U.S. LLCs

Under the "check-the-box" regulations, a domestic LLC with at least two members is classified as a partnership for U.S. federal income tax purposes, unless it files IRS Form 8832 ("Entity Classification Election") and affirmatively elects to be treated as a corporation. An LLC with only one member is treated as an entity disregarded as separate from its owner for U.S. federal income tax purposes (but as a separate entity for purposes of U.S. Federal employment tax and certain U.S. federal excise taxes), unless it files IRS Form 8832 and affirmatively elects to be treated as a corporation.

If an LLC is treated as a partnership, normal partnership tax rules will apply to the LLC, and it will file IRS Form 1065 ("U.S. Return of Partnership Income") on an annual basis. Each owner will be responsible for reporting on their individual income tax returns their share of partnership income, credits, or deductions reflected on the Form Schedule K-1 (1065) ("Partner's Share of Income, Deductions, Credits, etc.") issued by the LLC. Generally, each owner of an LLC that is

treated as a partnership and who is an active participant in the LLC's business pays self-employment tax on their share of partnership earnings.

On the other hand, if the LLC has elected to be treated as a corporation, normal corporate tax rules will apply to the LLC. It will file IRS Form 1120 ("U.S. Corporation Income Tax Return") on an annual basis, and the income tax attributes of the corporation will not flow through to any shareholders on their IRS Form 1040 ("U.S. Individual Income Tax Return"), unless a qualifying LLC also elects to be treated as an S corporation. (See IRS Publication 3402, "Taxation of Limited Liability Companies," for further discussion.)

C. The Major "Drivers" Behind Preference for the U.S. LLC Form

On the one hand, from the corporate or non-tax perspective, the LLC offers the ability to obtain all the asset protection and creditor protection features of the corporate form due to the limited liability of the members, where no member (not even the managing member) has to have unlimited liability. At the same time, the LLC offers great flexibility for allocating member and manager rights and responsibilities and determining the duration of the entity, among other things.

On the other hand, U.S. tax rules offer LLCs and their owners the ability to avoid the "dual taxation" regime associated with C corporations, where the income of the corporation is taxed as if the corporation were a separate taxpayer and the earnings and profits of the corporation are taxed a second time to shareholders when dividends and other non-liquidating distributions are made. The LLC also offers the ability to avoid certain restrictions otherwise imposed on corporations that elect S corporation status, which includes (1) the inability to have non-U.S. shareholders, (2) the requirement that, on liquidation, shareholders pay tax on their share of the unrealized gain of assets distributed to the shareholders as part of the liquidation, and (3) the inability to make an IRC section 754 election to step-up the basis of the corporation's underlying assets on the death of a shareholder. For an S-corporation, losses passed through to a shareholder can also generally only be deducted against other income to the extent of the shareholder's contributions to the corporation—because borrowing by the corporation does not affect a shareholder's basis in the corporate stock.[2]

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[1] The official name assigned to the 2017 Tax Reform Act that was signed into law by President Donald Trump on Dec. 22, 2017 is an "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." The act was formerly known as the Tax Cuts and Jobs Act of 2017.

[2] All that being said, the 2017 Tax Reform Act radically shifts the tax rate impact of choosing the LLC form over the corporate form, as the corporate income tax rate has been reduced to a flat rate of 21%. Assuming dividends paid to shareholders would be taxed at the favorable qualified dividend rate of 23.8%, the effective combined federal income tax rate for investing through the corporate form would be 39.8% instead of 37% (the highest rate for individuals picking up income from an LLC taxed as a partnership). The 2017 Tax Reform Act introduced a special deduction to try to restore some of the savings many had come to expect by operating as an LLC. A 20% deduction may be claimed on Qualified Business Income ("QBI") under new IRC section 199A, which has the potential of reducing the effective tax rate on QBI to 29.6%. Taxpayers, however, must qualify under the rather complex requirements and thresholds of the QBI deduction regime. The ability to benefit from the deduction is capped based on wages paid by the business or amounts invested in machinery, equipment, or real estate, among other things. The

extent of the deduction is also tied to an LLC member's allocable share of wages paid by an LLC to its employees, which might create a preference—at least for some U.S. taxpayers—to do business through S corporations rather than LLCs

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