TAXATION OF LEGAL ENTITIES:

From Disregarded Entities to Electing Small Business Trusts

Many investors and business owners hold their investments, or operate their businesses, through limited liability companies (LLCs). The basic arrangement sounds simple enough; however, deciding on the legal entity to use in these situations is only part of the process of implementing a sound investment or operational structure. Once the type of entity is decided upon, specifically in the case of LLCs, investors and business owners have the ability to elect how these entities will be categorized for tax reporting purposes.

BY JEREMY COOPER, ESQ.

This goal of this article is to present various tax considerations for contemplation when selecting a legal entity, with the caveat that taxation is only one element of many that should be explored when establishing an entity and its ownership structure. Furthermore, the content below and the accompanying chart are only meant to provide a summary of the options available to investors and business owners, and should not be relied upon without the assistance of a professional. Moreover, while a spectrum of options ranging from Disregarded Entities to S Corporations are covered below, this article primarily focuses on the taxation of these entities within the context of LLCs.

A common misconception among those dealing with LLCs is that LLCs file their own tax returns each year and that there is no need to discuss the taxation of these entities. As noted in more detail below, this is wholly inaccurate.

Limited Liability Company Taxation

The Internal Revenue Service (IRS) does not recognize the LLC as a taxable entity. As such, there is no specific tax reporting form or methodology unique to LLCs; rather, the IRS provides default designations for LLCs, depending on the number of members or owners, and these designations determine the tax forms to be filed and specific tax regime for that entity.[1] However, as discussed in more detail below, the LLC taxation discussion should not end with a simple acceptance of the IRS' default designations, as the IRS also allows LLC owners to opt out of these designations and elect to be taxed as C Corporations or S Corporations.[2]

Taxed as a Disregarded Entities

As an example, if an LLC has one member, the LLC will be designated a Disregarded Entity by default.[3] In other words, for tax purposes, the entity does not exist and is essentially treated as a sole proprietorship. All items of income, deduction, gain, loss and credit are reported on a Schedule C, E or F of an individual's personal income tax return. However, the entity is still recognized and respected from a legal standpoint. Assuming legal formalities are met and personal assets are not commingled with LLC assets, then the limited liability protections of the LLC are still available to its owner, unlike in the case of a Sole Proprietorship.

Taxed as a Partnership

If the LLC has more than one member, the LLC will be classified as a partnership by default.[4] Because partnerships are considered flow-through entities for income tax purposes, the partnership itself is not subject to income taxation. Instead, the individual items of income, deduction, gains, loss and credit flow through to the individual partners' personal returns and are taxed at the respective individual's income tax rates. The LLC files a Form 1065 Return of Partnership Income, allocating taxable income and loss allocated to the member partners on Schedules K-1, which each partner then reports on his or her own respective individual Form 1040.

Taxed as a C Corporation

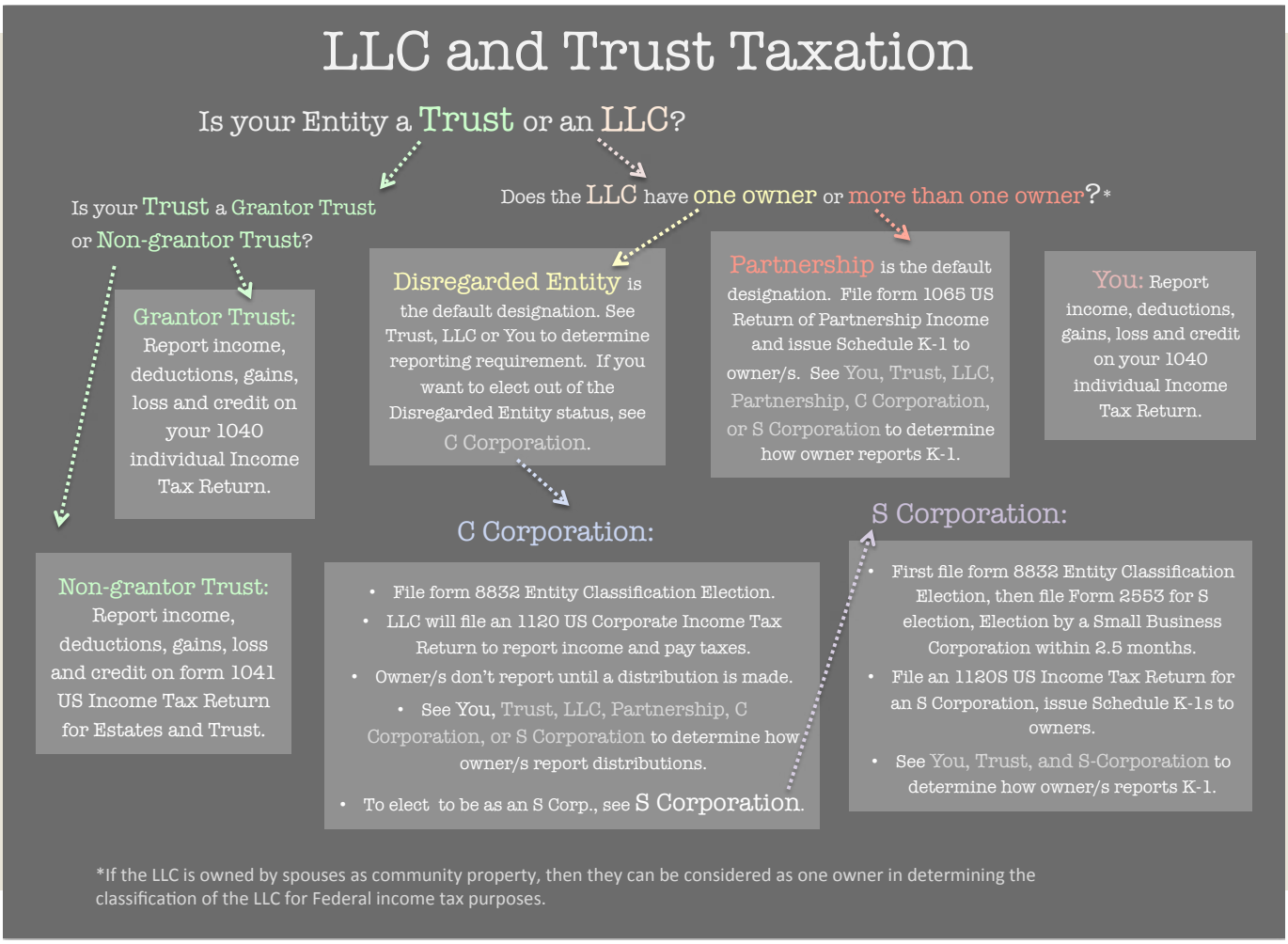
As noted above, the IRS allows for an LLC to elect out of the default rules and choose a different manner of taxation for the entity. If an LLC chooses to be taxed as a C Corporation, it would make this election by filing an Entity Classification Election, Form 8832. Upon filing this form, the LLC will be regarded as a C Corporation for income tax purposes and, as such, will be required to report all items of income, deduction, gains, loss and credit on a form 1120 Corporate Income Tax Return. C Corporations are subject to graduated corporate tax rates that are applied to the LLC's taxable income. If an LLC that is taxed as a C Corporation makes a dividend distribution to its members, the distribution will be taxed as income to the receiving member at the individual member's rate. Hence, a "double tax" applies to the LLC taxed as a C Corporation – first on the LLC's return, and then on the member's return, if a dividend distribution is made by the LLC.

Taxed as an S Corporation

Because most LLC owners would prefer to avoid the double taxation noted above, it is generally preferable to either accept the default classification as a partnership or to elect to be taxed as an S Corporation.[5] S Corporations can also be used to reduce self-employment taxes. Similar to a partnership, an S Corporation is a flow-through entity. The income, deduction, gains, loss and credit of the LLC are reported on a Form 1120S, Income Tax Return for

continued on page 8

TAXATION OF LEGAL ENTITIES continued from page 7



an S Corporation, and then allocated to the individual members via Schedules K-1, and reported on their individual Form 1040s. As such, any taxable income generated by the LLC will avoid taxation at the entity level and will only be subject to the member's individual income tax rates.

In order to elect to be taxed as an S Corporation, in addition to filing a Form 8832, the taxpayer would file an Election by a Small Business Corporation, Form 2553. This form needs to be filed within two and a half months of the formation of the entity; however, late election relief is available if the election is not made timely. Furthermore, only certain types of individuals and entities can own interests in an S Corporation, or the corporation will forfeit its S election and become subject to corporate tax rates.[6] As an example, only certain types of trusts can own S Corporation interests. Those trusts are Grantor Trusts, Qualified Subchapter S Trusts and Electing Small Business Trusts.[7] Grantor Trusts and Electing Small Business Trusts are discussed below.

Trust taxation

Grantor Trusts

A Grantor Trust is similar to a disregarded entity, in that the settlor reports the taxable income and losses attributable to the assets of the trust on the settlor's individual Form 1040 as if the trust did not exist at all. As such, the trust's taxable income is subject to the same rates and rules as would be applicable to the settlor.

Internal Revenue Code (IRC) Sections 671 through 679 will determine whether a trust is a Grantor Trust. If a trust contains a power or interest that is covered in those IRC Sections, the income of the trust will be taxed to the deemed grantor individually. Common examples of powers that result in Grantor Trust status are the powers to add charitable beneficiaries, to make loans to the grantor without adequate security, to substitute assets or to pay premiums on life insurance policies.

Electing Small Business Trusts (ESBTs)

An ESBT is a type of Non-Grantor trust (one that reports its own income) that may hold S Corporation stock without forfeiting the corporation's S election and the accompanying benefits of flow-through taxation.[8] ESBTs can be a very effective tax planning tool, as the IRC requires that income earned by an S Corporation attributable to stock owned in an ESBT be taxed at the trust level on a Form 1041 Fiduciary Income Tax Return in

the year it is reported for tax purpose, regardless of whether or not it is distributed.[9]

In other words, even if distributions from an ESBT are made to beneficiaries in the year the income is recognized for tax purposes, the ESBT does not receive a deduction for such distributions and, consequently, the beneficiaries aren't required to report the income attributable to said distribution on their individual income tax returns.[10] Moreover, there is no requirement that the distributions be reported on a Schedule K-1, as would be the case with a distribution from any other Non-Grantor Trust.

While these unique features of taxation may not seem that consequential on their face, when an ESBT is properly applied to fitting circumstances, the potential for tax rate and jurisdictional nexus shifting is profound. However, a state's laws regarding the taxation of distributions from trusts need to be closely scrutinized to ensure that no form of throwback rules, or rules that would allow for the state to tax income accumulated in a trust already taxed in another jurisdiction.

CONCLUSION

LLC taxation is not as simple as it might seem on the surface. Counseling a client on the manner of taxation for these entities is not a matter that should be undertaken lightly, as certain options can result in a much greater tax exposure than others. As with any area of the law, it is important to understand the options available so legal advisors can counsel their clients accordingly and allow them to make informed decisions. ■

1 Internal Revenue Service *Publication 3402: Taxation of Limited Liability Companies*, (Rev. March 2010), 2.
2 Treas. Reg. 301.7701-3.
3 Treas. Reg. 301.7701-3(f)(2).
4 Treas. Reg. 301.7701-2(a).
5 IRC Section 1362(a).
6 *See* IRC Section 1361.
7 IRC Section 1361(c)(2).
8 IRC Section 1361(c)(2)(v).
9 *See* Treas. Reg. Section 1.641.
10 Treas. Reg. Section 1.641(c)(i).

JEREMY COOPER is a co-founder and attorney with the law firm of Cooper Coons, Ltd. He focuses his practice on the areas of estate planning, asset protection and tax planning. He can be reached at jeremy@coopercoons.com or (702) 998-1500. The author would like to thank Serena Baig, an attorney with Cooper Coons, Ltd., and Natalie Marshall, a CPA with Bradshaw Smith & Co., for their invaluable insight and contributions to the article.