

Pros/Cons and Drafting Tips for LLCs Taxed Under Subchapter S

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Reasons to Use LLC as S-Election Entity

- **Corporate Formalities**
 - TBOC requirements more rigid for corporations than LLCs
 - ✦ Informality beneficial to closely-held LLCs
 - ✦ Informality can be taken too far

- **Management Flexibility**
 - Shareholder/Director/Officer Corporate Model
 - Member-Managed versus Manager-Managed
 - ✦ Default of One Vote Per Member – TBOC 101.354
 - Less than unanimous consent by governing authority
 - ✦ TBOC 6.202 versus TBOC 101.358
 - Informal approval – TBOC 101.359

Reasons to Use LLC as S-Election Entity

- Assignee Status
 - Restriction on free transferability – TBOC 101.108
 - Default of approval by other members – TBOC 101.109
- Ability to Restrict Duties & Liabilities
 - TBOC Section 101.401
- Charging Order / Asset Protection
 - Addresses owner-based liability
 - Exclusive remedy of judgment creditor – TBOC 101.112

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Reasons for an LLC to Elect Subchapter S

- Self Employment / Net Investment Income Taxes
- ESOPs
- ISOs
- Real Estate Development

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Employment Taxes -- S Corp

- Allocable income share not subject to SE Taxes
- Reasonable compensation is subject to Employment Taxes
 - IRS may contest – inverse of C corp constructive dividend cases
 - Multiple factors plus independent investor test
- 3.8% tax on net investment income (“NII”) under section 1411 generally applies to income not subject to SE tax, but does not apply to trade or business income in which the taxpayer is “active” under section 469 (determined at SH level)
 - Pass-through income is NII for inactive shareholders but not for active owners (who ostensibly would have earned a salary)
- Thus, allocable income share may not be subject to SE Taxes or NII for active SH who has been paid reasonable compensation

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Self Employment Taxes -- LLC

- Law is Unclear – Congress passed a one-year moratorium on finalizing 1997 proposed regs, then never acted further
- SE tax applicable to partner’s share of income from T/B but inapplicable to LPs under 1402(a)(13) (designed to keep LPs from getting social security credit)
- *Renkemeyer* (TC 2011) (lawyers’ distributive shares from LLC not subject to 1402(a)(13)); *Reither* (D. NM 2012) (working members of LLC not LPs); *Howell* (TCM 2012) (guaranteed payments for LLC member don’t fall under 1402); Did *Howell*’s focus on “guaranteed payment” walk back *Renkemeyer*?
- CCA 201436049: Distributive shares of partners/LLC members performing services is not investment income excluded under 1402(a)(13)

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