LEGAL ADVISOR

A PilieroMazza Update for Federal Contractors and Commercial Businesses

Tax Ramifications upon Exiting Your LLC

By David Medalia

Much has been written about the choice of taxable (as opposed to legal) entity in the context of government contractors. While there are certainly specific tax considerations that should be taken into account pertaining to business *formation*, it is equally important to consider the impact that the choice of taxable entity can have upon exiting the business. The tax election can lead to a wide variety of consequences, and has the potential to facilitate or impede a successful business sale.

At the outset, it must be said that limited liability companies ("LLCs") provide the most flexible legal entity through which to operate a business from cradle to grave. An LLC allows its members both the limited liability of a C corporation, and the ability to elect a single layer of taxation, such as in a partnership. In fact, an LLC can elect to be taxed as a subchapter C or subchapter S corporation, or as a partnership. This is in stark contrast with an entity formed as a corporation, which can never elect to be taxed as a partnership, pursuant to Internal Revenue Code ("Code") § 7701(a)(2) and Treasury regulation § 301.7701-3(a). Given these parameters, this article focuses on the tax treatment upon exit from LLCs that elect to be taxed as partnerships and S corporations.

LLCs Taxed as Partnerships

When a member of an LLC taxed as a partnership decides to sell its interest in the business, and if the member sells less than a 50% interest in the partnership, then Code § 741 controls. That section grants the seller capital gains rates, except for certain unrealized receivables and inventory items taxed at ordinary rates under Code § 751. A seller is only taxed on the amount it receives above its outside basis in the partnership interest.

For example, let's consider the case of Anthony, who paid $50,000 for a 25% partnership interest in ABCD LLC ("ABCD"). Eleanor later buys Anthony's partnership interest for $100,000. At the time of Eleanor's purchase, Anthony had loaned ABCD $10,000, and had earned $75,000 of partnership income, $40,000 of which ABCD had distributed to him. Breaking it down, Anthony's outside basis would be his initial contribution of $50,000 plus the $10,000 he loaned ABCD, plus the $75,000 in partnership income he earned, minus the $40,000 of distributions he received. The total basis would be $95,000, meaning he would be taxed on $5,000 of capital gain (which would be long-term capital gain if he held the partnership interest for more than a year).

Alternatively, if a partnership interest of 50% or more is exchanged within a twelve-month span, a technical termination is deemed to occur pursuant to Code § 708(b). Using our example above, let's say Eleanor buys the partnership interests of Anthony, Bill, and Chris for $100,000 apiece. Further, each of the three selling partners holds a 25% partnership interest with adjusted outside bases of $95,000, $120,000, and $100,000, respectively. Anthony would have $5,000 of income taxable at capital gains rates to the extent the partnership interest did not involve unrealized receivables and inventory items; Bill would have a $20,000 loss, and would try to claim as much of the amount as possible was related to Code §751 items to obtain an ordinary loss, rather than a capital loss (which can only be offset against capital gains); Chris would break even.

The aggregate acquisition would trigger a technical termination of "old" ABCD, as more than 50% of the partnership would be acquired in a twelve-month span. That would entail old ABCD being deemed to contribute

Continued on page 2

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its assets and liabilities to "new" ABCD in exchange for an interest in new ABCD. Immediately thereafter, old ABCD would make a liquidating distribution of partnership interests to Anthony, Bill, and Chris for $100,000 apiece. The technical termination would cause ABCD's tax year to end at the time of sale, and would permit the company to make new partnership elections.

LLCs Taxed as S Corporations

The S corporation has a range of attributes that render it both tempting and dangerous for unsuspecting business owners. It offers limited liability and a single layer of tax, but there are negatives as well. S corporations may only have one class of stock, no more than 100 shareholders, and the IRS has placed limits on who those shareholders can be. Further, if an S corporation violates one of the aforementioned limitations, the IRS can impute C corporation taxation onto the entity, resulting in an unwanted second layer of taxation.

In liquidation, shareholders of an S corporation resemble both a partnership and a C corporation. Like a partnership, the shareholders of an S corporation include current year income in their basis, but unlike partners, S corporation shareholders cannot add liabilities assumed to their basis.

S corporation liquidations are subject to the rules of subchapter C. As such, Code § 331 applies to calculate gain or loss to shareholders on complete liquidation. That Code section provides that amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as full payment in exchange for the stock. For example, if Eleanor bought 100% of the shares of ABCD, an LLC taxed as an S corporation, for $6 million, each shareholder would be taxed as if he had sold all of his stock back to ABCD for cash. If Anthony had a basis of $1 million in his shares (25% of the company's total shares), which, on a pro rata basis were purchased by Eleanor for $1.5 million, Anthony would have $500,000 of capital gain.

This is just the tip of the S corporation iceberg; the subchapter has a myriad of confusing rules that can thwart uninformed investors. It is important for prudent business owners to take the time to understand the tax consequences of their entity selection on the front end, to ensure they obtain a positive result when it is time to sell.

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