LLC Taxed as an S Corporation — Be Careful

By Kolbie McCabe and Peter Beach

It is common today to include in a discussion about choice of entity the possibility of forming an LLC (Limited Liability Company) that elects to be taxed as an S corporation. The choice is not appropriate for everyone, but it warrants consideration in many cases. Further, while making the election is simple, ensuring that the election is valid is not.

The Internal Revenue Code gives LLCs a great deal of flexibility regarding entity classification for federal income tax purposes. An LLC can elect to be taxed as a C corporation by filing IRS Form 8832 and as an S corporation by filing IRS Form 2553. (It is not necessary for an LLC electing to be taxed as an S corporation to also file Form 8832.) Beware that due diligence may be required to guarantee that an LLC's election to be taxed as an S corporation is valid, including a review of the LLC's operating agreement.

When to Review

Practitioners need to know when to perform the due diligence review. Whenever any of the following situations arise in your practice, be sure to review the entity's operating agreement so that any election is made validly:

1. An existing or newly formed LLC wants to be taxed as an S corporation to reduce its self-employment tax liability;
2. An S corporation wants to convert to an LLC under the NH conversion statute and retain taxation as an S corporation;
3. An LLC that had previously elected to be taxed as a C corporation now wishes to elect taxation as an S corporation; or
4. A C corporation wants to convert to an LLC and elect to be taxed as an S corporation.

Changes to the LLC Operating Agreement

The changes that must be made to a standard LLC operating agreement are not complex. Primarily, an operating agreement should not refer to the member's capital accounts and the tracking thereof. All provisions controlling distribution, allocation, and liquidation should state that such transfers are to be made *pro rata* in accordance with the members' LLC interests, as is required of all S corporations.

Practitioners should also ensure that an LLC's operating agreement does not create more than one class of interests. Beware that the creation of more than one class of interest may not be so obvious. Under the S corporation regulations, an S corporation has more than one class of interest if members have different distribution and liquidation rights. Some LLC operating agreements provide for preferential treatment for certain members without acknowledging that more than one class of interests exists. For example, if an LLC's operating agreement gives preferential distribution rights to its founders and not other members, then there may be two classes of membership interest even though the agreement does not actually use terms that refer to separate classes, such as "Class A Common" and "Class B Preferred."

In order to take advantage of the Interest and Dividends Tax benefits available for New Hampshire LLCs, the LLC's interests must be non-transferable according to the terms of its operating agreement. At a minimum, the non-transferability rules, which are beyond the scope of this article, require the consent of another non-transferring member (or perhaps a majority of the non-transferring members) before a member may transfer its interest in the LLC.

It is also important that the operating agreement be amended to treat as null and void any transfer of an interest in the LLC to a transferee that does not qualify as an eligible S corporation shareholder. Ineligible S corporation shareholders include nonresident aliens, partnerships, LLCs, and C corporations.

Consequences of Losing S Corporation Status

If an LLC loses status as an S corporation, then it should revert to the taxation method used before the S election was made. For example, if an LLC first elects taxation as a C corporation and subsequently files an invalid S election, then the LLC will revert to taxation as a C corporation. If an LLC files an invalid S election without first filing for C corporation taxation, some argue that the LLC should revert back to taxation as a partnership or disregarded entity under the default classification rules. Others take the position that the S election, whether valid or not, makes the LLC taxable as a C corporation if the S corporation election is later found to be invalid.

Fortunately, there is a safety net, albeit an expensive one, for inadvertently invalid S elections. An LLC that discovers any provisions in its operating agreement that would invalidate its election for taxation as an S corporation can request relief from the IRS in the form of a request for a private letter ruling. Also, the IRS is expected to publish a Revenue Procedure addressing common missteps in due diligence for entities taxed as S corporations, which may identify key issues for practitioners in this field.

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