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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Legal Developments in Employee Benefits Plans in 2018

By John E. Rich Jr.

While tax practitioners were spending the bulk of 2018 attempting to understand the intricacies of the Tax Cuts and Jobs Act of 2017 (the Act), there were still significant developments impacting employee benefit plans.

This article highlights a few of the significant 2018 developments impacting employee benefit programs. A common theme seen in these developments is the federal government's attempt to enhance access to retirement and health benefits.

Let's All Come Together, Association Health and Retirement Plans

Following the issuance of a 2017 Executive Order intending to promote healthcare choice and competition, the United States Department of Labor (DOL) began working on guidance to facilitate the purchase of health insurance across State lines.

On June 21, 2018, the DOL issued a final regulation under Title I of the Employee Retirement Income Security Act (ERISA) that established criteria for determining when employers may join together in a group or association of employers that will be treated as the sole "employer" sponsor of a single multiple-employer employee welfare benefit plan and group health plan.

The final regulation sets forth the criteria under which groups or associations may establish an ERISA-covered multiple employer group health plan.

Most significantly, under the so-called "commonality of interest" test, any employer can join with other employers in a self-funded or insured association health plan if (i) the employers are in the same trade, industry, line of business, or profession, or (ii) each employer has a principal place of business in the same region that does not exceed the boundaries of a single state or metropolitan area (even if the metropolitan area includes more than one state).

In addition, the group or association also must have at least one substantial business purpose unrelated to offering and providing health coverage or other employee benefits.

The final regulation significantly expands the groups of employers that can be treated as a single large employer group for claims experience and all other federal law purposes.

However, the regulation does not change Section 514 of ERISA which permits states to regulate association plans which could limit their applicability in states wishing to maintain the current rules.

Later in 2018, the DOL turned its attention to expanding access to association retirement plans following a similar Executive Order directing expansion of retirement plan coverage.

On October 23, 2018, the DOL issued a proposed regulation designed to clarify the circumstances under which an employer group or association or a professional employer organization may sponsor a workplace retirement plan. These plans are referred to as "MEPs," or multiple employer plans.

The proposed regulation adopts criteria very similar to that of the final association health plan regulation with respect to the required connections between participating employers. The MEP regulation is only proposed and could have significant changes in the final version including further lessening of the

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