

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

ISSUE NO. 41 (MARCH 8, 2007)

**DRAFTING FEDERAL TAX PROVISIONS FOR THE LLC
AGREEMENTS OF LLCs TAXABLE
AS S CORPORATIONS**

EXECUTIVE SUMMARY

For smaller companies both in New Hampshire and in other states, the best possible structure is to be an LLC for law purposes and an S corporation for federal tax purposes. The LLC agreement of such an LLC should contain, in addition to the usual purely legal provisions, special federal tax provisions addressing key Subchapter S issues. These Subchapter S provisions should include, above all, a provision requiring the LLC to select as its tax adviser a CPA or EA who is expert in Subchapter S and to consult with this adviser regularly.

DISCUSSION

For almost all businesses in New Hampshire and in most other states, the strong liability shield of the LLC form and its legal and tax flexibility and informality make it by far the best business organization form. However, most smaller New Hampshire LLCs—i.e., those that provide compensation to their members of less than the Social Security Tax base—\$97,500 for 2007—should make an S election in order to minimize their Social Security Tax burden (assuming that they and their tax advisers assume that to avoid this tax is in their best long-term interest). If they make this election, they will incur the New Hampshire Business Profits Tax on their net income (at a rate of 8.5%, but the tax will be deductible federally), but they will save Social Security Taxes at a rate of 15.3%. In states that treat S corporations as pass-through entities for state tax purposes, the net tax saving can be much greater.

However, if an LLC is an S corporation for federal tax purposes, should its LLC agreement (called an operating agreement in Massachusetts and most other states) contain any special Subchapter S tax provisions?

- 1) In my view, the operating agreement should *not* contain summaries of any of the Subchapter S entity-level and shareholder-level rules governing eligibility for S corporation eligibility nor any other Subchapter S substantive rules as such. Most members won't understand or remember these rules and will only be annoyed by them.

- 2) Rather, the purpose of the Subchapter S provisions in the agreement should be to set forth rules and structures that teach the members about the importance of properly making an S election and maintaining it until the day (which, however, will probably never come) when the members decide to voluntarily revoke it.
- 3) In particular, the agreement should provide as follows:
 - a) The agreement should provide that before or promptly after the formation of the LLC and the signing of the agreement, the members must find a CPA or EA who is an expert in Subchapter S and must appoint this individual as the LLC's tax adviser, and it should contain a general provision requiring the members to consult with this tax adviser about all significant plans and activities of the LLC to ensure that they will not create risks under that subchapter.
 - b) In addition, the agreement should contain a section that specifically identifies all of the various types of transactions that can terminate or significantly jeopardize the LLC's S election and that specifically requires the members to consult with the LLC's tax adviser before effecting any of these transactions. The section should provide more or less as follows:
 - (1) Allocations and Distributions. The members shall consult with the LLC's tax adviser before the LLC makes any allocation or distribution not previously approved by the LLC's tax adviser.
 - (2) Member Compensation, Etc. The members shall consult with the LLC's tax adviser before the LLC makes any change in its compensation to the members for their services to or for the LLC.
 - (3) Issuance of Shares, Etc. The members shall consult with the LLC's tax adviser before the LLC issues (a) any shares or other LLC membership rights to any member or to any other person; or (b) any warrant or option for any such shares or other membership rights.
 - (4) Sale of Shares, Etc. The members shall consult with the LLC's tax adviser before any member sells, gives or otherwise transfers or disposes of all or any part of the member's shares or other membership rights to another member or to any other person.
 - (5) Redemptions. The members shall consult with the LLC's tax adviser before the LLC redeems all or any part of any member's shares or other membership rights.
 - (6) Loans. The members shall consult with the LLC's tax adviser before any member makes any loan to the LLC and before the LLC makes any loan to a member.
 - (7) Withholding of Taxes, Etc. The members shall consult with the LLC's tax adviser before the LLC withholds or pays taxes on behalf of the members to any federal, state or other tax authority in a manner not already approved by the tax adviser.

- (8) Change in Estate Plan. Each member shall consult with the LLC's tax adviser before the member makes any change in his or her will or in any trusts or other estate planning documents or arrangements of the member.
- (9) Acquiring Ownership Interests in Another Entity. The members shall consult with the LLC's tax adviser before the LLC acquires an ownership interest in any other entity.
- (10) Change of LLC's Purpose, Etc. The members shall consult with the LLC's tax adviser before making any change in the LLC's purpose or lines of business.
- (11) Change of Accounting Method or Taxable Year. The members shall consult with the LLC's tax adviser before changing the LLC's accounting method or taxable year.
- (12) Death of a Member. Upon the death of a member, the other members shall use reasonable best efforts to consult with the LLC's tax adviser about possible Subchapter S issues that may arise because of the death.
- (13) Other Actions. The members shall consult with the LLC's tax adviser before any member or the LLC takes any other action relating to the LLC or its business or internal affairs outside the ordinary course of the LLC's business.