AN OVERVIEW OF MODIFICATIONS TO AN OPERATING AGREEMENT FOR A LIMITED LIABILITY COMPANY ELECTING TO BE TAXED AS AN S-CORPORATION

By James F. Anderton, V

As almost all practitioners are aware, as well as many clients interested in creating an entity, a limited liability company ("LLC") may elect to be taxed as an S-corporation for purposes of Federal income taxes. While this basic fact appears to be widely-known, there is scant literature regarding what changes this election will require in the organizational documents of the LLC. This article attempts to give practitioners an overview of the major issues involved in drafting organizational documents for an LLC that will be taxed as an S-corporation.

Why Entities Make the Election

As most readers of this article know, a frequent motivation for entrepreneurs electing S-corporation status is to reduce the impact of employment taxes. Individuals who use LLCs they are members of to engage in a trade or business will generally be subject to self-employment taxes on all of the earnings of the LLC allocated to them[1] (currently 15.3% of the net earnings from the trade or business[2]). However, owners of S-corporations who work for their entities are treated as employees of the corporation.[3] This allows the owners to take reasonable salaries, which will be subject to the employment taxes of 15.3%, although half of that will be paid by the entity and allowed as a deduction for the entity (while the remaining half will be paid by the employee and reported on the employee's W-2). The tax advantage is that the S-corporation owners do not have to report all of the net earnings of the corporation as wages, and can have those amounts distributed out of the entity without being subject to self-employment taxes[4] (although the owner's percentage of income and losses will be subject to income taxes[5]). This allows the owners of S-corporations to save some employment taxes in certain situations.

The question left unanswered is why entrepreneurs desiring to be taxed as an S-corporation would want to operate in the form of an LLC instead of a corporation. The author believes the reason for this is in large part due to entrepreneurs' perception that there are fewer entity formalities required by the owners of an LLC as compared to corporations. This belief has support in Michigan law, as the Members of an LLC are not required to meet annually[6], while the shareholders of a corporation must meet annually to comply with the Michigan Business Corporation Act.[7] While the practical differences for many closely held entities between formalities required of a corporation and an LLC are likely minimal (i.e., if three people own 100% of the entity and work for the entity on a daily basis, how much extra work does a set of minutes for the shareholders and the board once a year entail), anecdotal evidence suggests this is a significant factor when entrepreneurs describe their preferred operating structure.

How The S-Election is Made

To the surprise of no one familiar with S-corporations, the election to be taxed as an S-corporation for an LLC is made by filing Form 2553 with the Internal Revenue Service ("IRS"). The IRS does not require the Form 8832 (Entity Classification Election) to be filed, as any entity that timely files Form 2553 will be deemed to have made the necessary election under Treasury Regulation 301.7701-3(c)(v) to be taxed as a corporation.[8] All of the standard requirements for an entity to be eligible to make an S-election, such as number of shareholders/members[9], types of shareholders/members[10], and having one class of stock[11] (more-properly membership interest in this context) all continue to apply to LLCs.

An S-election can only be made by filing Form 2553 within (a) the first 2 months and 15 days of the taxable year the election is to be effective[12], or (b) the taxable year prior to the taxable year the election is to be effective.[13] For LLCs seeking S-corporation treatment in their first taxable year, the shareholders/members must be made aware that they have 2 months and 15 days to timely make such election.[14] Advisors should keep in mind that all shareholders/members must sign the Form 2553.[15]

Impact on S-Election of Organizational Documents

Once the decision has been made for the LLC to make the S-election, the issue becomes how best to modify the organizational documents to account for the various limitations placed on the electing entity by the Internal Revenue Code ("IRC"). Given the minimal amount of information required to be in the articles of organization for a Michigan LLC[16], there is no need to add the IRC's limitations on S-corporations to the articles. However, some practitioners may find it useful to insert some or all of the requirements of

Subchapter S of the IRC, especially those relating to shareholder/member eligibility, to protect against accidental terminations of the S-election. By having the provisions available to the public, any potential future shareholder/member investigating the entity can review the restrictions to see if they may be applicable, and discuss the issue with the current shareholders/members and appropriate counsel.

In the operating agreement for the LLC, the S-election will generally require numerous changes to the following areas, which will be examined in more detail below: a) shareholder/member eligibility and transfer of interests, b) allocations of income and loss, c) distributions of cash and other property, and d) incurring debt. However, before going into those details, a brief review of the flow-through taxation of an S-corporation may be helpful. Generally, an S-corporation pays no taxes; instead, the income and deductions of the entity are reflected on the tax returns of its owners.[17] Since special allocations of income and deductions are not allowed in S-corporations, the income and deductions must be allocated based on pro-rata ownership.[18] An important difference between S-corporations and other flow-through entities such as LLCs and partnerships is that any third-party debt of an S-corporation does not increase the owners' basis in their ownership interest.[19] This is why most entities that incur debt to purchase significant depreciable assets are not taxed as S-corporations.

Another issue the practitioner should consider is having the "stock" of an LLC taxed as an S-corporation qualify as IRC §1244 stock. This may allow for the owners to convert a capital loss into an ordinary loss. Under Reg. §301.7701-3(g), when an LLC elects to be taxed as a corporation, the LLC is deemed to contribute all of its assets and liabilities to a corporation for all of the stock of the corporation, and then the LLC liquidates and distributes the stock to its members for tax purposes. This should allow for the entity to issue "stock" eligible for IRC §1244 treatment, provided the other requirements of the section are also met. A full examination of the features of §1244 is beyond the scope of this article, but it is a concept that may prove valuable in certain circumstances.

Impact of S-corporation on Shareholder/Member Eligibility and Transfer of Interests

There are stringent limitations as to who is eligible to be a shareholder of an S-corporation. Generally, eligible shareholders of an S-corporation are individuals who are United States citizens, certain special trusts and estates, and certain tax-exempt entities.[20] Further, the entity may have no more than 100 shareholders, although there are rules allowing for the possibility of substantially more shareholders in certain circumstances.[21]

The net effect of the above-described rules on the operating agreement for an LLC electing to be taxed as an S-corporation is that the operating agreement should include language that if a shareholder/member of the entity is either an ineligible shareholder/member, or causes the total number of shareholders/members to exceed the 100 shareholder/member limit, the Company or other shareholders/members should have the right to purchase such shareholder's/member's ownership interest. Further, the provisions regarding transfer of an interest should allow the entity to vet the proposed transferee of an interest to insure the above rules will not be violated.

Impact of S-election on Shareholders'/Members' Allocations of Income and Loss

Another significant rule to qualify as an S-corporation is that the entity may have only one class of stock. As alluded to above, this means each share of stock (or membership unit if the entity is an LLC for state law purposes) must have "identical rights to distribution and liquidation proceeds."[22] Importantly for governance considerations, voting differences in stock are excluded from the determination of classes of stock.[23] *Id.*

A significant ramification of the one-class-of-stock requirement is that agreements to purchase the interest of a shareholder, designed either as a buy-sell agreement or a redemption agreement, must not unduly benefit one shareholder or the agreement will risk violating this rule. The regulations make clear that buy-sell and redemption agreements will be disregarded in evaluating the one-class-of-stock requirement unless the purpose of the agreement is to (1) circumvent the rule and (2) the agreement sets a price, at the time the agreement is entered into, that is significantly above or below fair market value.[24] The careful reader will note that an agreement must violate both provisions of the regulations to be considered in evaluating the classes of stock. The regulations specifically bless a purchase price based on book value[25], even though book value often bears little relation to fair market value.

In drafting an operating agreement, the rules contained in Reg. §1.1361-1(l)(2)(iii) must be kept in mind. While these rules allow for many valuation techniques to be used to arrive at a purchase price for a buy-out or redemption, including use of appraisals, book value, and formulas based on earnings in many instances, the universe is closed. When the agreement is entered into, the determination of purchase price must arrive an amount defensibly close to fair market value and not unduly benefitting one (or more) shareholder/member to the detriment of the remaining shareholders/members.

Once S-status is elected for the LLC, all of the requirements of Subchapter S of the IRC must be complied with at all times by the entity or the status will be automatically terminated.[26] One of the fundamental requirements of Subchapter S is that all entities subject to it have only one class of stock.[27] Again, the Treasury Regulations make clear this rule does not apply to voting rights, but only to distribution and liquidation proceeds.[28] Further, IRC §1366(a)(1) requires each owner of the S-corporation take into account such owner's pro-rata share of the entity's items of income, loss, deduction or credit.[29] Thus, Subchapter S effectively eliminates the enormous flexibility of special allocations afforded to the owners of entities subject to the partnership rules of Subchapter K. While special allocations are not permitted, the drafter of the operating agreement would do well to specifically state that all of the entity's items of income, gain, loss, deduction or credit shall be allocated among the shareholders/members on a pro-rata basis. Further, this allows for the cumbersome paragraphs regarding the regulatory allocations of the §704 allocations to be removed from the operating agreement.

Impact of S-election on Distributions to Shareholders/Members

Pursuant to the one-class-of-stock rule described above, and as should naturally follow from the allocation rules explained above, all distributions from the entity, both liquidating and non-liquidating, must be pro-rata based on number of units owned.[30] The operating agreement should state this, so that there is no discretion for a manager or managing-shareholder/member to have a distribution to only one shareholder/member (as may well happen if a majority-interest holder wants to take a little extra cash out in any given year). Failure to comply with this requirement will result in a termination of the S-election.

Impact of S-election on Incurring Debt

The final issue this article will explore relating to the one class of stock rule involves debt. Frequently in operating agreements, when a capital call is made and one (or more) shareholder/member does not participate, that shareholder's/member's interest can be diluted or even deemed sold to the other shareholders/members after a period of time that the non-participating shareholder/member does not repay the amount contributed by the other shareholders/members on his/her account. Additionally, for both tax and business purposes, the shareholders/members classify the money contributed to the entity as loans instead of a true capital contribution. The risk for an LLC taxed as an S-corporation is that these loans, especially loans which may result in an increased membership interest due to one (or more) shareholder's/member's failure to make a loan, may be a second class of stock.[31] This is even more of a concern as the regulations discuss obligations treated as equity under general principles and the loans will generally be made under the capital call provision of the operating agreement.

The easiest way to avoid this issue is to have every shareholder/member who makes a loan to the entity have the loan qualify under the "straight-debt" safe-harbor of Reg. §1.1361-1(l)(5). To meet the safe-harbor, the debt must meet the following requirements: 1) it must be written, 2) it must pay a sum certain on either demand or a specified date, 3) the interest rate is not dependent on profits, dividend payments, or the entity's discretion, 4) is not convertible into stock, 5) is held by an eligible shareholder/member.[32] If this approach is elected, a provision requiring compliance with this Regulation should be considered.

Allowing for capital calls to be made with loans leaves a question of what to do with the owner who did not participate. Diluting his/her interest could cause the debt to be deemed as a second class of stock and thus destroy the S-election, or if treated as an actual capital call, the price will need to comply with the rules described above relating to buy-sell and redemption agreements (which would seem to be hard to do as the diluted/selling shareholder/member is actually receiving nothing for the interest being transferred to the contributing shareholders/members). One approach to still punish the non-contributing owner is to require that the loan be paid in full before any other distributions to owners can be made, thus reducing the cash flow to the non-contributing owner. Further, the loans can have an above market-rate interest rate, which has the effect of further punishing the non-contributing owner as more of the cash of the entity will be used to repay the interest on the loans. As practitioners spend more time analyzing this issue, other and better solutions will doubtlessly be created.

FINAL THOUGHTS

There are certainly other changes to an operating agreement that an S-election may trigger. The author suggests explicitly including language allowing for an S-election in a clause related to either the entity's purpose or description of the entity's activities that may be contained in the operating agreement. However, the author hopes the foregoing will serve as a useful resource for those first grappling with this issue, and that it may spark more literature to help fill the void in this area.

ABOUT THE AUTHOR

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ENDNOTES

1 Internal Revenue Code ("IRC") §1402

2 IRC §1401(a) and (b)

3 Treas. Reg. §31.3121(d)-1(b)

4 IRC §1368

5 IRC §1366

6 MCLA §450.4502

7 MCLA §450.1402

8 Form 8832 (Revised January 2011), Page 5

9 IRC §1361(b)(1)(A)

10 IRC §1361(b)(1)(B)-(C)

11 IRC §1361(b)(1)(D)

12 IRC §1362(b)(1)(B)

13 IRC §1362(b)(1)(A)

14 Note that the IRS does have a procedure for those entities wishing to make the election but failed to timely file due to a reasonable cause. See Form 2553 (Revised December 2007).

15 IRC §1362(a)(2)

16 MCLA §450.4203

17 IRC §1363(a); IRC §1366

18 IRC §1366(a)(1)

19 IRC §1367(a)(1)

20 Treas. Reg. §1361-1(b)(1) and IRC §1361(c)(6)

21 IRC §1361(c)

22 Treas. Reg. §1.1361-1(l)(1)

23 *Id.*

24 Treas. Reg. §1.1361-1(l)(2)(iii)

25 *Id.*

26 IRC §1362(d)(2)

27 IRC §1361(b)(1)(D)

28 Treas. Reg. §1.1361-1(l)(1)

29 IRC §1366(a)(1)(A)

30 Treas. Reg. §1.1361-1(l)(1)

31 *Id.*

32 Treas. Reg. §1.1361-1(l)(5)