S Election Terminated as a Result of Form Operating Agreement Language

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A limited liability company (an "LLC") is a business structure created by state statute, but it is not a distinct business entity for tax purposes (like a partnership or a corporation). Instead, businesses structured as LLCs are taxed under the provisions of the Internal Revenue Code applicable to sole proprietorships, partnerships or corporations, depending upon who owns the LLC at issue, the number of members of the LLC, and certain elections made by the LLC. By default, a single-member LLC is disregarded as an entity separate from its owner for tax purposes and a multi-member LLC is taxed as a partnership. However, certain regulations promulgated by the Department of the Treasury, commonly referred to as the "check the box" regulations, permit an LLC to affirmatively elect out of these default rules.

One option available to an LLC under the check the box regulations is to elect to be taxed as an S corporation. Like a partnership, an S corporation is a type of entity that passes items of income, gain, loss, deduction and credit through to its owners for tax purposes. Unlike a partnership, however, certain taxpayers are prohibited from owning an interest in an S corporation, there are limits on the number of permissible owners, and the type of interest a taxpayer may own in an S corporation is restricted to a single class. In considering whether to make an election to be taxed as an S corporation, it is important to remember that the LLC must comply with these unique requirements at all times in order to maintain its status as an S corporation.

The rule prohibiting an LLC that has elected to be taxed as an S corporation from having multiple classes of ownership may sometimes be violated inadvertently, as evidenced by a recent private letter ruling, and it is important for tax practitioners to review boilerplate provisions of an LLC's operating agreement to determine whether revisions are necessary prior to electing S corporation status.

In determining whether there is more than one class of ownership, state law regarding classes of ownership is not considered. Pursuant to Treasury Regulations § 1-1361-1(l)(1),

[A] corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

It is important to note that, under the Treasury Regulations, the relevant inquiry is based upon the members' respective *rights to distributions* and not on the distributions actually made to members. As a result, distributions that differ in timing (for example, a distribution of $10,000 in Year 1 to Member A and

a distribution of $10,000 in Year 2 to Member B) will generally not result in the creation of different classes of ownership so long as the members are entitled to equal distributions and the difference in the timing of the distributions does not occur by reason of a binding agreement relating to distribution or liquidation proceeds.[1] On the other hand, if an agreement among the members provides for circumstances where distributions to the members may be disproportionate, then the LLC will be deemed to have a second class of ownership even if every distribution actually made to the members has been strictly proportional.

The operating agreement of the LLC at issue in PLR 201918004 contained the following provision:

"Upon dissolution of the Company . . . the proceeds from the liquidation of the Company's assets shall be distributed . . . to the Members in accordance with their respective positive Capital Account Balances; and, the balance, if any, to the Members, in accordance with their respective Percentage Interests."

This language directing distributions to be made to members in accordance with their respective positive capital account balances is regularly included in operating agreements to satisfy the substantial economic effect safe harbor of Treasury Regulations § 1.704-1(b)(1), which is important for LLCs *taxed as partnerships*, but the result of this language is that distributions to members may not be made on a proportional basis in all situations. Based on the fact that the operating agreement contemplated circumstances where distributions to the members was not strictly proportionate based on the members' respective interests in the LLC, the IRS concluded that LLC's S election was terminated on the date the operating agreement was adopted.

This private letter ruling highlights the importance of reviewing an entity's governing documents prior to making an election to be taxed as an S corporation. Regardless of whether S corporation status is retroactively restored (as was the case in PLR 201918004), an inadvertent termination of a taxpayer's S status can be costly. Because the IRS must affirmatively determine that any termination of a taxpayer's S status was inadvertent, a taxpayer cannot simply take the position that the termination event should be ignored. Rather, the taxpayer is required to request relief via an application for a private letter ruling, which results in additional costs and expenses for the taxpayer.

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[1] *See* Treas. Regs. § 1.1361-1(l)(2)(vi), Ex. 2.