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Unlimited Tax Liability: A Common Misnomer of Limited Liability Company Taxation in the United States

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Abstract

Since its existence, the limited liability company (LLC) has become a commonly selected business entity structure in the United States. One of the major advantages of this entity structure is the limited personal liability provided to the owners of the business. A common misnomer however among business owners whom structure their business as an LLC is the notion that the limited liability protection extends to shielding them from being personally liable for the taxes of the business. This misnomer leads business owners to unexpectedly face personal tax liabilities and related repercussions. This article highlights this widespread issue and provides guidance to domestic and foreign business owners on the appropriate United States federal tax guidelines applicable to LLC taxation. The article also addresses the new regime of tax audit rules under the Bipartisan Budget Act of 2015 that impact LLC tax liability.

Keywords: Small Business, Entrepreneurship, Limited Liability Company, LLC, tax liability

Introduction

Since its existence, the limited liability company (LLC) has become a commonly selected business entity structure in the United States. One of the major advantages of this entity structure is the limited personal liability provided to the owners of the business. A common misnomer however among business owners whom structure their business as an LLC is the notion that the limited liability protection extends to shielding them from being personally liable for the taxes of the business. This misnomer leads business owners to unexpectedly face personal tax liabilities and related repercussions.

This article highlights this widespread issue and provides guidance to domestic and foreign business owners on the appropriate United States federal tax guidelines applicable to LLC taxation. The primary two questions this issue brings forth are the following:

> Question 1: Who is liable for the tax resulting from the operation of a single member LLC?
>
> Question 2: Who is liable for the tax resulting from the operation of a multi-member LLC?

In Chief Counsel Advise 200235023 (8/30/2002), Mitchel Hyman, a Senior Technician Reviewer with the IRS, addressed these two critical questions related to the collection of tax liabilities from an LLC. A summary of the major points of the memorandum are included in this article to provide the foundation for domestic and foreign persons to understand the taxing scheme of an LLC.

Further, the Bipartisan Budget Act of 2015 implements a new regime of tax audit rules that impact the tax liability of an LLC and its owners. The article discusses the key changes relative to LLCs and also provides model provisions for LLC operating agreements to address the relevant tax audit rules impacting LLCs under the Bipartisan Budget Act of 2015.

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History of the Limited Liability Company (LLC)

The LLC is a relatively new form of business organization. Wyoming was the first state to authorize LLCs in 1977. The purpose was to provide an organization that had the tax benefits of a partnership and the limited liability benefits of a corporation. The IRS at first proposed to tax LLCs as corporations because none of the owners had unlimited liability, as they do in a partnership. The IRS issued proposed regulations to that effect in 1980. The proposed regulations were withdrawn in 1983 due to a lack of support. The IRS concluded in 1988, after a six year study of the LLC issue, that an LLC could be taxed as a partnership even if none of the owners were personally liable. After this ruling, other states enacted laws authorizing LLCs. Today, all of the states and the District of Columbia have LLC laws. In 1996, the Treasury issued final regulations permitting LLCs with two or more members to be classified as partnerships. The regulations are referred to today as “check-the-box” regulations because they permit LLCs to elect classification as a proprietorship, partnership, or corporation for federal tax purposes by checking the applicable box on an IRS form. These regulations were issued in response to the numerous LLC state statutes that blurred the distinction between corporations and partnerships.

An LLC is a hybrid entity created under state law, which has attributes of both a partnership and a corporation. The owners of an LLC are called members, who generally are not liable for the debts or liabilities of the LLC. The law of most states permit an LLC to be structured as a single member LLCs, LLCs having only one member commonly known as the single member owner, or a multi-member LLC, LLCs having two or more members. Due to a lack of specific statutory guidance applicable to LLCs, revenue rulings and private letter rulings issued by the IRS are the prevalent tax laws applying the tax rules to LLCs. An analysis of the single-member LLC and multi-member LLC taxing schemes follows below.

Single-Member LLC Taxation

For a single member LLC, the determination must be made as to whether an election has been made to have the LLC treated as an entity taxable as a corporation for federal tax purposes. If this election has been made, the LLC will be treated as a separate legal entity that may accrue its own tax liability. In this situaiton, the IRS may collect that liability only from the LLC’s assets. In essence, just as a sole shareholder is not liable for the corporation’s tax liability, the single member owner of the LLC would be similarly insulated from the LLC’s federal tax liability.

If the single member owner has not elected to be treated as an entity taxable as a corporation, the default provision of the check-the-box regulations provides that the LLC is to be disregarded. As a result, the single member owner is the taxpayer for liabilities arising from the operation of the LLC. This leads to a number of problems for the single member taxpayer.

As the taxpayer liable for federal income taxes arising from the LLC’s operations, the single member owner must file the federal income tax returns from which the IRS can make assessments. Regardless of whether an assessment of a disregarded LLC contains the name and/or taxpayer identification number of the single member owner, such an assessment is valid against the single member owner. Given a valid assessment and notice and demand upon the single member owner, the taxpayer, the Service would have a tax lien that it could enforce against the taxpayer’s property and rights to property.

The IRS has concluded that the taxpayer’s property and rights to property do not encompass the LLC’s property. In Drye v. United States, 528 U.S. 49 (1999), the Supreme Court has articulated a two prong test to determine a taxpayer's property and rights to property. First, a taxpayer's interests or rights must be determined under state law. Second, one must determine whether such interests or rights are property or rights to property under the Internal Revenue Code. If under the first prong, it is determined that a taxpayer has no interest or rights under state law, it follows that the taxpayer has no property or rights to property under the Internal Revenue Code.

I.R.C. Section 6321 provides that if any taxpayer neglects or refuses to pay the tax liability after demand, the amount shall be a lien in favor of the United States upon all of the taxpayer's property and rights to property. I.R.C. Section 6331(a) authorizes the Service to collect a tax liability by levy upon a taxpayer's property or rights to property after a taxpayer's CDP rights are satisfied. I.R.C. Section 7403(a) authorizes the Government to file suit to foreclose the federal tax lien on property.

Applying the above analysis under the Drye test to the single member owner of a disregarded LLC, the single member owner has no property or rights to property in the LLC's assets. This is because under the first prong of the Drye test, the IRS looks to state law to determine a taxpayer's interest. However, under state law, the taxpayer has no interest in the LLC's property. Therefore, even though the LLC's activities are treated in the same manner as a sole proprietorship, branch, or division of its single member owner for federal tax liability purposes, the IRS cannot satisfy the single member owner's tax liability from the disregarded LLC's assets. Interesting to note is that under the Internal Revenue Code, the IRS may levy upon the member's ownership interest in the disregarded LLC and sell that interest, or the IRS may file suit to foreclose the federal tax lien against the ownership interest.

Multi-Member LLC Taxation

A multi-member LLC can be elect to be taxed as either a corporation or partnership for federal tax purposes. Assuming that a multi-member LLC has elected to be treated as an entity taxable as a corporation, the IRS would apply the general rules of corporate taxation. In this instance, the LLC is taxed as a corporation and the members would be the equivalent of shareholders in the corporation. To satisfy either the LLC's tax liability, the IRS could file either an assessment against the LLC and file suit to foreclose the federal tax lien or levy on the LLC assets.

Most multi-member LLCs are taxed as partnerships. As a result, any income tax liability arising from an LLC's activities flows through to its members. If the Service files a collection action to collect the income tax liability, a partner's name as the taxpayer is listed for collection. A major difference, however, exists between a general partner's liability for the partnership's employment taxes and a member's liability when an LLC is treated as a partnership and incurs an employment tax liability: while each general partner is derivatively liable for the full amount of the employment tax liability under state law, no member of the LLC has any liability for the employment tax liability under state law. The IRS recognizes that state law creates the difference in treatment between general partners and LLC members, not federal law. When a partnership incurs an employment tax liability, under state law the general partners are liable for the tax, just as they are liable under state law for other debts of the partnership. Subsequently, when the IRS files a collection action in this situation, the IRS lists the name of the partnership and the names of the known general partners, so that notice is provided of the federal tax lien encumbering not only the partnership assets but also the general partners' assets.

In contrast, when an LLC has incurred an employment tax liability as a partnership, there is no state law imposing a derivative liability on the LLC's members. State law explicitly provides that a member is not liable for an LLC's debts. Consequently, the IRS cannot collect an employment tax liability from an LLC's member, even though the LLC is treated as a partnership for federal tax purposes. This is a caused by the members having no derivative state-law employment tax liability. An IRS collection action for that liability should not be filed against the members, but solely in the name of the partnership as the taxpayer.

Bipartisan Budget Act of 2015 Partnership Tax Effect

Provisions included in the Bipartisan Budget Act of 2015 change the rules for tax audits and contests of partnerships in the United States. A partnership under the Act means any entity that is classified as a partnership for U.S. tax purposes. This includes limited liability companies and foreign (non-U.S.) entities with more than one partner/owner/member that have elected to be classified as partnerships for U.S. tax purposes.

Under the The Tax Equity and Fiscal Responsibility Act of 1982, the United States created a centralized partnership audit system. The generally rules applicable to the subject of this article include:

- The tax treatment of all partnership items is determined at the partnership level.

- The partnership or LLC designates a "tax matters partner" who must be a partner or member of the entity to represent it in tax proceedings. The tax matters partner generally has the right to extend the statute of limitations, file for refunds and settle proposed adjustments, and is the person the IRS will normally deal with during the audit process.

The new partnership audit rules allow the IRS to impose the burden of paying the resulting tax on the partnership, allow the partnership to push the liability to its partners or members, and to deal exclusively with a single tax representative of the partnership.

Partnership Level Tax Liability

The new partnership audit rules impose the liability for tax adjustments on the partnership or LLC, rather than its partners or members.

- The imputed underpayment is generally calculated by netting all audit adjustments and multiplying the net underreported income by the highest marginal U.S. federal income tax rate, regardless of the actual tax rates applicable to the partners.

- The tax liability payment is made for the tax year of the adjustment, not the tax year under review.

- The partnership also owes interest, and possibly penalties, on the deemed underpayment.

- There is no netting of benefits and costs to partners.

Electing Out

There are two ways that a partnership may elect not to pay the tax:

- A partnership may elect out of these rules entirely by noting on its partnership return if (i) it has 100 or fewer partners, and (ii) none of its partners are partnerships or trusts. If a partnership elects out, the IRS may still audit the partners, but will generally be unable to perform a unified audit of the entire partnership. The election to opt out is made for each taxable year, so a partnership may be eligible to make the election in one year but not another.

- If on audit of a partnership that has not elected out, the IRS assesses the partnership, the partnership may avoid paying the adjustment by instead issuing revised Schedule K-1s or similar forms to its partners, effectively passing the tax obligation up to the partners. This is known as the "push-up election."

Partnership Representative

Under the new partnership audit rules, a tax matters partner is replaced by a "partnership representative." A partnership representative is not required to be a partner of the partnership. The only requirement is that the representative has a substantial presence in the United States. Further, the partnership representative has the exclusive right to take action with respect to a partnership audit, which includes litigating or settling IRS claims.

Current U.S. partnership and LLC agreements contain rules for dealing with tax audits under The Tax Equity and Fiscal Responsibility Act of 1982. As the new partnership audit rules become effective, these agreements (and the agreements of newly formed partnerships and LLCs) will need to incorporate provisions reflecting the changes under the Bipartisan Budget Act of 2015. The following sample model provisions, which can be incorporated into partnership or LLC agreements, provide for a tax matters partner or partnership representative and related matters.

Tax Representation

(a) For purposes of Code Section 6231(a)(7), ______ is designated as the initial "tax matters partner" ("TMP") for tax years ending before January 1, 2018. For tax years ending after December 31, 2017, the Person serving as the TMP on January 1, 2018 (or the successor of such Person pursuant to Section X.x(b)) shall be the designated "partnership representative" of the Company within the meaning of Code Section 6223 ("Tax Representative"). The Tax Representative shall have sole authority to act on behalf of the Company for purposes of subchapter C of Chapter 63 of the Code and any comparable provisions of state or local income tax laws. For purposes of this Section X.x, unless otherwise specified, all references to provisions of the Code shall be to such provisions as enacted by the Bipartisan Budget Act of 2015.

(b) The Person serving as the TMP or Tax Representative shall be automatically removed as TMP or Tax Representative upon the death, dissolution and/or winding up, legal incompetency or Bankruptcy of such Person, and the Person serving as the TMP or Tax

Representative may be removed at any time by [the Managers or] the Members. Upon such removal of the TMP or Tax Representative, a successor to serve in such position shall be designated by [the Managers or] the Members.

(c) If the Company qualifies to elect pursuant to Code Section 6221(b) (or successor provision) to have federal income tax audits and other proceedings undertaken by each Member rather than by the Company, the Company shall make such election.

(d) Notwithstanding other provisions of this Agreement to the contrary, if any "partnership adjustment" (as defined in Code Section 6241(2)) is determined with respect to the Company, the Tax Representative, in the discretion of the Tax Representative, may cause the Company to elect pursuant to Code Section 6226 to have any such adjustment passed through to the Members for the year to which the adjustment relates (i.e., the "reviewed year" within the meaning of Code Section 6225(d)(1)). In the event that the Tax Representative has not caused the Company to so elect pursuant to Code Section 6226, then any "imputed underpayment" (as determined in accordance with Code Section 6225) or "partnership adjustment" that does not give rise to an "imputed underpayment" shall be apportioned among the Members of the Company for the taxable year in which the adjustment is finalized in such manner as may be necessary (as determined by [the Managers/the Members] in good faith) so that, to the maximum extent possible, the tax and economic consequences of the partnership adjustment and any associated interest and penalties are borne by the Members based upon their interests in the Company for the reviewed year.

(e) Each Member agrees that, upon request of the Tax Representative, such Member shall take such actions as may be necessary or desirable (as determined by the Tax Representative) to (1) allow the Company to comply with the provisions of Code Section 6226 so that any "partnership adjustments" are taken into account by the Members rather than the Company or (2) file amended tax returns with respect to any "reviewed year" (within the meaning of Code Section 6225(d)(1)) to reduce the amount of any "partnership adjustment" otherwise required to be taken into account by the Company.

Conclusion

Domestic and foreign business owners of an LLC can face personal tax liability given the federal tax election they choose. To recap, Treasury Regulation Section 301.7701-1 et seq., commonly referred to as the check-the-box regulation, provides a framework for the federal tax classification of entities. Under this regulation, the classification of an LLC will depend on the number of members in the LLC and the election filed for the LLC. A single member LLC can be treated as either an entity taxable as a corporation or as a disregarded entity. A single member owner could elect to have the LLC classified as a corporation for tax purposes. If no election is made, the LLC will be disregarded as an entity separate from its owner. A disregarded LLC's activities are treated in the same manner as a sole proprietorship, branch, or division of the owner for tax purposes. Since a disregarded LLC is not separate from its owner for federal tax purposes, the single member owner is deemed the taxpayer with respect to tax liabilities arising from the LLC's business. As a result, the IRS may collect any tax liability by assessing the single member owner and pursuing administrative collection action. Alternatively, a multi-member LLC may elect to be treated as an entity taxable as a corporation. If no election is made, the treasury regulations provide as a default that the LLC will be treated as a partnership for tax purposes. Finally, current and newly formed LLCs will need to incorporate new provisions into their operating agreements to reflect the tax audit changes under the Bipartisan Budget Act of 2015. These changes significantly impact the tax liability of LLCs and their members.

By understanding the importance of selecting the appropriate tax classification of an LLC, domestic and foreign business owners can strategically determine if they want to keep their personal assets from being subject to potential tax liabilities. Therefore, minimizing the risk of this misnomer of LLC limited liability protection.

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8) I.R.M. 5.19.4.6.3(6).

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11) Prop. Reg. § 301.7701-2, 45 Fed. Reg. 75709 (Nov. 17, 1980).

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