LLCS AND S CORPORATIONS

An Update on Pending Legislation

William C. Staley
ATTORNEY
www.staleylaw.com
(818) 936-3490

Hollywood/Beverly Hills Chapter
CALIFORNIA SOCIETY OF CPAS
West Los Angeles

June 18, 2010

LLCS AND S CORPORATIONS

An Update on Pending Legislation

TABLE OF CONTENTS

1. American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213) 1

2. Small Business Tax Bill (H.R. 5486) 5

3. "Disqualified S Corporations" (H.R. 4213) 6

4. Carried Interests (H.R. 4213) 7

5. Section 83 and Partnership Interests (whether or not "carried" H.R. 4213)......13

6. Synthetic ("disqualified") interests in entities (H.R. 4213) 14

7. Thinking about ignoring these new rules? 15

Copyright © 2010
All rights reserved

William C. Staley, Attorney
6303 Owensmouth Avenue, 10th Floor
Woodland Hills, CA 91367
www.staleylaw.com
(818) 936-3490

This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

LLCS AND S CORPORATIONS

An Update on Pending Legislation

William C. Staley
Attorney
www.staleylaw.com
(818) 936-3490

June 18, 2010

Note: This outline discusses proposed legislation that is not law today and may never become law. These bills could change substantially if they are enacted, and could change substantially during the legislative process even if they are not enacted. Unlike most enacted laws, the "legislative history" of these bills is still being made, and there is no definitive interpretation of them by the IRS or any agency or court. Be extra careful about relying on the discussion in this outline for any purpose.

---

1. American Jobs and Closing Tax Loopholes Act of 2010 (H.R. 4213)

1.1. Status:

- Passed in House.
- In Senate Finance Committee. Controversial. Prospects uncertain.
- On Senate floor. Amendment proposed by Senator Baucus (Chair of the Senate Finance Committee) failed on 6-15-10. Senator Baucus proposed a substitute amendment on 6-16-10.
- Failed a cloture vote by four votes on 6-17-10. Senator Baucus confident that he can get the votes needed to pass some version of the bill.

- *6-26-10 update:* An amended version failed another cloture vote on 6-25-10. The bill appears to be dead. However, the revenue raising provisions might be inserted in other bills.

1.2. Tax cuts and extenders:

- Extends for one year (there are many others):
    - R&D credit
    - 15-year recovery period for leasehold improvements
    - 5-year recovery period for farm equipment
    - Allows S corp shareholder to take entire share of corporate-level charitable contribution, even if the shareholder does not have sufficient basis in his shares to absorb the deduction.
    - Allows film and television producers to expense the first $15 million of production costs incurred in the United States ($20 million if the costs are incurred in economically depressed areas).

1.3. Tax increases:

- **Carried interest**. The bill would recharacterize certain capital gain of investment fund managers (their "carried interest") in an investment fund as ordinary income.[1]
    - To the extent that carried interest reflects a return on invested capital, the bill would continue to tax carried interest at capital gain tax rates.

---

[1] Sections 411 and 412 of the Bill amending IRC Sections 83(b) and (c) and adding a new Section IRC 710.

- To the extent that carried interest does not reflect a return on invested capital, the bill would treat 75% of that carried interest as ordinary income (50% for taxable years beginning before January 1, 2013).

- Effective for taxable years ending on or after 1-1-11.

- Expected to raise $18.7 billion over 10 years.[2]

- **Social Security Taxes for Professional Firms**[3]

  - For a "disqualified S corporation," all of the flow-through income under IRC Section 1366 is treated as income from self-employment -- to certain shareholders.

    - ⇨ Whose flow-through income? Each shareholder who provides substantial services (not necessarily professional) "with respect to" the "professional services business."

    - ⇨ AND Each of his family members who do not provide substantial services to the "professional services business."

  - Dividends continue to be excluded from "self-employment income."[4]

  - Applies to

    - An S corporation that is engaged in a "professional service business" AND the business is

---

2 JCT estimate. Daily Tax Report (BNA) 5-24-10, 98 DTR G-8.

3 Section 413 of the Bill amending IRC Section 1402 and Section 211 of the Social Security Act.

4 I.R.C. § 1402(a)(2).

principally based on the reputation and skill of 3 or fewer individuals, or

  - An S corporation that is a partner in a "professional service business."

- Removes the self-employment tax exclusion for limited partners if they provide "substantial services with respect to" a "professional services business" in which the limited partnership engages. (Not limited to limited partners that are S corporations.)

- Definition of "professional service business" broader that for cash method business (listed in IRC Section 448) and includes lobbying, athletics, investment advice or management and brokerage services.[5]

  - Also includes services in the fields of health, law, engineering, architecture accounting, actuarial science, performing arts and consulting, all allowed the cash method.

  - Not as broad as "personal service corporation," though, so don't confuse the two.[6]

- Expected to raise $11.2 billion over 10 years.[7]

- Effective date: Tax years beginning after 12-31-10.

---

[5] It's also broader than the definition of a "professional service corporation" in Treas. Reg. § 1.414(m)-1(c) ("certified or other public accountants, actuaries, architects, attorneys, chiropodists, chiropractors, medical doctors, dentists, professional engineers, optometrists, osteopaths, podiatrists, psychologists, and veterinarians").

[6] A "personal service corporation" has as its principal activity the performance of services and substantially all of those services are performed by employee-owners. I.R.C. § 269A(b)(1). The IRS can reallocate income between an PSC and its employee-owner just as it can between related businesses under IRC Section 482. I.R.C. § 269A(a).

[7] JCT estimate. Daily Tax Report (BNA) 5-24-10, 98 DTR G-8.

1.4. Other provisions

- Extends an SBA loan program

2. Small Business Tax Bill (H.R. 5486)

2.1. Status:

- Introduced 6-10-10.
- Proposed to be tacked on to the Small Business Lending Bill (H.R. 5297) during the House floor debate.
- Passed by House 6-15-10.

2.2. Tax cuts (temporary):

- 100% exclusion for capital gains on the sale of small business stock
  - Must be held for 5 years
  - Acquired between 3-15-10 and 1-1-11
- First-year deduction limit for start-up expenses would be increased from $5,000 to $20,000 for 2010 and 2011.
- Tax shelter and listed transaction penalties would be made proportionate to the tax benefit received.

2.3. Tax increases (permanent):

- GRATS would be required to last for at least 10 years.
- Limits cellulose bio-fuel credit for paper manufacturers.

3. **"Disqualified S Corporations" (H.R. 4213)**

3.1. Has nothing to do with eligibility to be an S corporation or the S corporation election.

3.2. The S corp is a partner in partnership, AND:

- The partnership is engaged in a "professional service business," AND

- Substantially all of the S corp's activities are performed "in connection with" the partnership.

- Example: An incorporated partner in a law or accounting firm.

3.3. OR The S corp is itself engaged in a "professional service business" AND

- AS PASSED BY THE HOUSE: "The principal asset of the business is the reputation and skill of three or fewer employees."

  - Note: The employees need not be shareholders. It is not "The reputation and skill of three or fewer *shareholders*."

  - Why not four or more employees? Presumably because it becomes more likely that capital and not services generate more of the profit as the size increases?

- SENATOR BAUCUS (CHAIRMAN OF SENATE FINANCE COMMITTEE) PROPOSAL OF 6-16-10: "If 80% or more of the gross income of such business is attributable to service of 3 or fewer shareholders of such corporation."[8]

---

[8] S. Amendment 4369, as opposed to S. Amendment 4301 that failed earlier in the day.

- o Changes the task from identifying the "principal asset" to tracing the source of the gross income.

- o Changes the focus from employees to shareholders.

- o More administrable? How does an accountant know what gross income is attributable to the services of a particular shareholder? Easy if hourly rates are used? If not…? Even for the billable hour, is the gross income "attributable to" the rainmaker who plays golf with the client or the worker bee who bills the hours? Is this not what every professional firm struggles with endlessly for compensation purposes?

4. **Carried Interests (H.R. 4213)**

4.1. Would add a new IRC Section 710.

4.2. How does it work?

- It turns off the rule of IRC Section 702 that makes the flow-through income to a partner retain its character. All of the flow-through income or loss is treated as ordinary income or loss. Even if the partnership invests in the stock of companies, enhances the businesses of the companies and sells the stock recognizing long-term capital gain.

- It does not allow losses from one partnership to be used to offset income from other partnerships or activities. (But it appears to allow an infinite carryforward of loss realized after enactment.)

- Losses do not reduce the basis of the partnership interest until the loss is used to offset partnership income.[9]

---

[9] As passed by the House, the bill includes this rule: "In the case of any disposition of an investment services partnership interest, the amount of net loss which otherwise would have (but for [the rule about basis]) applied to reduce the basis of such interest shall be disregarded for purposes of this section [710] for all succeeding partnership taxable years." I don't understand it, but Senator Baucus proposed to eliminate it.

- Flow-through dividend income is taxes as ordinary income, not at the long-term capital gain rate.

- The ordinary income is treated as self-employment income for purposes of Section 1402(a).

- Gain on the disposition of the partnership interest is subject to special rules:[10]

    - It's all ordinary income, and

    - It cannot be tax-free, no matter what. It is always taxed when it is realized. Realization = recognition.

- Loss on the disposition of the partnership interest can be capital loss.

    - It is ordinary loss to the extent that the flow-through income after enactment was not offset by flow-through losses.

- If the partnership distributes appreciated property (like stock) to the partner, the partner recognizes the gain and gets a fair market value basis in the property.

    - The partner can use any basis increase that resulted from a Section 754 election in measuring the gain to be recognized.

    - If the distribution was a deemed distribution and contribution back as a result of a Section 708(b) technical termination of the partnership, the gain is not recognized.

(..continued)

[10] Modified by Senator Baucus's 6-16 amendment.

- An “investment services partnership interest” is treated as a “hot asset” like inventory or unrealized receivables. So if a partnership interest is sold and some of the gain is attributable to an “investment services partnership interest” held by the partnership, that gain will not be capital gain.

4.3. Applies to an “investment services partnership interest”

- The focus is on the role of the partner, not on the activities of the partnership. This rule is *not* limited to investment partnerships, for example.

- Focus is on the expectation at the time the interest was acquired, *not* what the partner actually did. (Administrable?)

- At that time, was it expected that the partner would provide specific services “with respect to [certain] assets held (directly or indirectly) by the partnership. So the issue is the extent to which the partner was expected to provide specific services involving certain partnership assets.

- What quantity of services is required? “A substantial quantity.” Over what period of time? Not stated. A year? No. As long as the partner held the interest? Maybe. As long as the partnership held the asset? Maybe. As long as the partnership held that type of asset? Maybe.

- What partnership assets are we talking about?

    - Securities,

    - Real estate held for rental or investment,

    - Interests in partnerships,

    - Commodities, or

    - Options or derivative contracts with respect to any of those.

- What services by the partner involving the partnership assets?

    - Advising as to the advisability of investing in, purchasing, or selling any specified asset.

    - Managing, acquiring, or disposing of any specified asset.

    - Arranging financing with respect to acquiring specified assets.

    - Any activity in support of those services (which captures the office staff of the private equity company or venture capital firm, if they get partnership interests).

- Would the promoter of a typical real estate project acquire an "investment services partnership interest"? Yes. It's about acquiring, financing and disposing of real estate held for rental or investment and the promoter provides all or most of the services.

- Would the promoter of a typical restaurant project acquire an "investment services partnership interest"? No. The promoter would not be managing real estate or financial assets.

4.4. The "qualified capital interest" is the part of the partner's partnership interest that has already been taxed. The draconian rules (for both flow-thought items and gain on disposition of the interest) do not apply to that part of the partnership interest. It's like a mini capital account (or it could be the entire capital account).

- Components of the "qualified capital interest":

    - Money the partner contributed to the partnership,

        - ⇨ But not if the money was loaned to the partner by another investment services partner.

- ⇨ Same if the other investment services partner guaranteed a loan to the acquiring partner or if a relative or affiliate of the other investment services partner made the loan or guarantee.

  - o The fair market value of property that the partner contributed to the partnership,

    - ⇨ Treasury is directed to provide for "proper adjustments" if the partner's basis in the property before the contribution is less than its value.

  - o Amounts included by the partner in income under Section 83 when the partner acquired the interest, and

  - o The excess of the flow-through income and gain on the "qualified capital interest" over the flow-through deduction and lost on the "qualified capital interest."

- Distributions and losses with respect the "qualified capital interest" reduce that interest.

- To avoid the draconian rules, the allocations on the "qualified capital interest" must be made in the same way as allocations to other partners with non-trivial interests who are not related to the partner and are not investment services partners.

  - o It's OK if the other partners get a higher preferred return than the investment service partner with the "qualified capital interest."

- If a partnership interest that is not an "investment services partnership interest" becomes such an interest, the value of the partnership interest of the investment services partner immediately before the change becomes a "qualified capital interest."

- For tiered partnerships, the flow-through on a "qualified

capital interest" from a lower-tier partnership retains its character as flow-through from a "qualified capital interest."

4.5. Any other exceptions?

- The draconian treatment of flow-through income and loss does not apply if the partnership *is* publicly traded *and* neither the partner nor any of his family members ever provides "any" of those services that he expected to provide that made the partnership interest an "investment services partnership interest" in the first place.

  - If the partnership is *not* publicly traded and the partner never provides "any" of those services, the partner is stuck with the draconian rules.

- The partner can contribute the "investment services partnership interest" to another partnership and have the nonrecognition rule of Section 721 apply *if* the partner agrees that (presumably all) of the new partnership interest will be an "investment services partnership interest."

4.6. Effective date (if enacted as passed by the House)

- Generally, to tax years *ending* after 12-31-10.

- Fiscal years including 12-31-10 – OK to apply to entire year or to apply only for income earned after 12-31-10.

- Applies only to dispositions of partnership interests after 12-31-10.

4.7. Phase in (the "applicable percentage")

- Applies only to 75% of the income, loss, gain and dividend income of an "investment services partnership interest" until 1-1-13, then it applies to 50%.

- o 6-16-10 Baucus proposed amendment: 50% applies only to interests held for more than five years[11]

- Note the implicit political threat: "We can ratchet this up at any time."

5. **Section 83 and Partnership Interests (whether or not "carried" H.R. 4213)**

5.1. A Section 83 amendment is proposed for receipt of a partnership interest by a person or entity who provides services to or for the benefit of the partnership.

5.2. A method for valuing a partnership interest is established for Section 83 purposes. The valuation date is the date on which the interest is "transferred" to the service provider.

- Pretend: That the partnership sells all of its assets at their fair market value on the valuation date, pays all of its debts, and distributes the remaining assets to its partners in liquidation (presumably, according to the partnership or operating agreement).

- What would the service provider receive in that distribution? That's the value of his carried interest Section 83 purposes.

- Note: A "transfer" is a term of art under Section 83. The recipient generally must acquire all of the upside and downside of ownership. Acquiring the interest with a nonrecourse note, limiting the downside or capping the upside can prevent (or, often worse, defer) a "transfer" of the interest to the service provider for Section 83 purposes.

---

[11] From Senator Baucus's summary of the 6-16-10 amendment: "This amendment provides that the lower recharacterization percentage also applies to the gain or loss attributable to the underlying assets held for 5 or more years when a partnership interest is sold as well as to gain attributable to section 197 intangibles of a partnership whose principal activity is providing specific investment management services with respect to the assets of the partnership when the partnership interest has been held for 5 or more years."

5.3. A "deemed" Section 83(b) election is made. The recipient of the interest can "unmake" the deemed election if the recipient wants to defer the income hit and risk a bigger ordinary income hit in a later year when the interest "vests."

6. **Synthetic ("disqualified") interests in entities (H.R. 4213)[12]**

6.1. New rule:

- Income or gain on synthetic interests in any entity will be ordinary income if the person performs investment services for the entity and the person holds a synthetic interest that changes its value or payout based on the income or gain on the managed assets, whether or not the gain is realized.

- The "already taxed" portion would be excluded from this rule by regs that should tract the rules for "qualified capital interests" held by investment services partners.

6.2. "Disqualified interests" are defined by what they are not:

- Not straight debt,

- Not a partnership interest,

- Not stock in an S corporation.

- Not stock in a "taxable corporation" - a U.S. C corp or a foreign corp that is taxed in the U.S. or is subject to a comprehensive foreign income tax (not a tax haven?), and

6.3. What are "disqualified interests":

- Interests other than the "not this" interests,

- Convertible or contingent debt of the entity,

[12] Would be subsection (e) of new IRC Section 710, but is not limited to partnerships or "investment services partnership interests."

- Options to acquire synthetic interests, and

- Derivative instruments entered into "with such entity or any investor in such entity."

6.4. Effective on December 31, 2010 (if enacted as passed by the House).

7. **Thinking about ignoring these new rules?**

7.1. There's a 40% penalty for underpayments in avoidance of new Section 710 (by amendments to Section 6662 in H.R. 4213).

[End of outline.]