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S Corporation LLCs – Sometimes a Great Notion[1]

By Mark Golding

When business and tax practitioners, especially the latter, think of the terms "limited liability company" ("LLC") and "S corporation," they often think in terms of "apples and oranges" or "never the twain shall meet." This is because an LLC is treated by default as a partnership or disregarded entity for tax purposes (collectively, "non-corporate tax entities" or "NCTEs"), unless it opts to check-the-box on Form 8832 to be taxed as a corporation. And, while S corporations and NCTEs are all generally taxed at the ownership level rather than the entity level[2], there are still substantial differences in taxation as between them.[3]

The label "LLC" is a local law entity classification, and domestic "state law" LLCs can, if they want, elect to be taxed as a corporation (whether C or S) rather than an NCTE.[4] Moreover, existing state law entity classification can be relatively easily changed from state law corporation to LLC or vice versa.[5] This invites the question, "Are there circumstances where an entity would choose both organization (or reorganization or conversion) as an LLC and taxation as an S corporation?"

This is really a double-pronged question. First, the entity must determine that federal (and state) taxation as an S corporation is preferable to that of both an NCTE and a C corporation. Second, the entity must also determine that, from a state law organizational standpoint, it will be better to operate as an LLC than, e.g., as a corporation (business or professional), a partnership (general or limited liability), a limited partnership or a sole proprietorship.

Why an S Corporation?

Let's address the choice of tax entity issue first. When is classification as an S corporation preferable? A complete discussion of choice of tax entity is clearly beyond

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the scope of this article. However, let's start with the premise that, while C corporations certainly have their place, most closely held businesses prefer "flow through" taxation to entity/owner double taxation, and the choice of tax entity is therefore normally between an S corporation and an NCTE.

The most obvious situation where S corporation tax status is preferable is an existing tax corporation (C or S).[6] Whether an entity is a C corporation looking for flow-through taxation or a pre-existing S corporation, changing to NCTE status will involve a deemed tax liquidation and most likely an immediate and substantial tax cost.[7] Even in situations where asset values approximate book value, there is often substantial zero basis goodwill that will make conversion to an NCTE unworkable.

What about newly formed entities? For most entities not already a corporation, the choice will be an NCTE. NCTEs are simply more flexible and tax friendly than S corporations in most ways: ownership criteria[8]; basis for debt, loss flow-through and cash distributions[9]; allowances for non-pro rata capital ownership, profits allocations, distributions and even special allocations of income or deduction[10]; nontaxable property distributions[11]; inside basis step-ups on ownership transfers[12]; and exit strategies[13].

If, however, the above flexibilities are either irrelevant to the specific situation or less important than a perceived S corporation tax advantage, S corporation tax classification might still have appeal.

For example, many entity owners have an extreme dislike for paying employment and/or self-employment taxes on their own business earnings. Knowing this, many tax advisors point out that one perceived S corporation tax advantage is that, while salary is subject to FICA, shareholder distributions are not[14], and shareholders have substantial leeway in allocating between the two.[15] By contrast, sole proprietors or tax partners are subject to self-employment taxes on the full amount of their shares of the NCTE's net earnings from self-employment.[16] Important exemptions from net earnings from self-employment include real estate rentals[17], dividends and interest[18], capital gains[19] and a limited partner's entire distributive share of partnership income[20]. Thus, for entities not in the real estate rental business or a business producing substantial dividends, interest and/or capital gains, S corporation shareholders have an advantage over sole proprietors and general partners in a tax partnership. On the other hand, since limited partners' distributive shares are completely exempt from self-employment tax, they have an advantage over even S corporation shareholders. The difficulty as to LLCs taxed as tax partnerships is that there is no concrete guidance distinguishing an LLC's general partners from its limited partners, terms generally inapplicable to LLCs. After Treasury's surprisingly workable 1997 proposed regulations on the subject [21] were almost immediately rebuked by Congress[22], Treasury, being once bitten, has steadfastly refused to issue any subsequent guidance. This leaves taxpayers in a quandary. While substantial planning opportunities exist under the discredited (but still outstanding) proposed regulations for many LLC members to escape most or all self-employment tax as a limited partner, many taxpayers (and their advisors) prefer the relative security and familiarity of the current S corporation regime.[23]

Another situation where S corporation status might be preferable is when an entity expects to be swallowed by a bigger entity in the foreseeable future. S corporation shareholders, by complying with the reorganization provisions of IRC § 368(a), can "sell" their S corporation (or its assets) to another corporation in exchange for stock (common and/or preferred) in the acquiror or its parent on a tax-free basis. By contrast, a similar transaction undertaken by a sole proprietor or a tax partnership would be completely taxable. Thus, a business entity looking to be acquired in a tax-free reorganization would have to do so as a corporation. It is true that an NCTE could, when the time is ripe, incorporate tax-free and thereby obtain the ability to reorganize under IRC § 368, but this presents potential pitfalls. One is that if the incorporation is part of a pre-arranged plan of reorganization, the incorporation will be ignored and the reorganization will fail.[24] A second trap is that, even assuming the incorporation and reorganization are respected, if the incorporating entity's liabilities exceed its asset basis at the time of incorporation, the excess will be taxed.[25] This problem is quite common in leveraged businesses whose balance sheets only show a small portion of the business assets' real value, e.g., where there is substantial tax depreciation, asset appreciation and/or zero basis assets, like cash basis accounts receivable and goodwill.

There are other small tax benefits an S corporation has over NCTEs[26], but generally these alone are insufficient to cause the business to elect S corporation status.

Why an LLC?

Assuming that S corporation tax status is considered preferable, why form as an LLC rather than as a state law corporation? The answer here is that LLCs do possess some non-tax advantages vis-à-vis state law corporations that might be considered important.

One advantage is in the area of liability. It is common knowledge that both LLCs and state law corporations offer similar protection for the owner's personal assets (i.e. those outside the LLC or corporation) from the entity's creditors, what some refer to as "inside-out" liability protection.[27] This is also the major reason business owners turn to LLCs or corporations rather than general or limited partnerships or sole proprietorships, where at least one owner has unlimited liability.

However, it is in the area of protection of the entity (and its other owners) from the creditors of a debtor owner ("outside-in" liability protection) that an LLC has advantages over a state law corporation, and these advantages are enhanced for S-Corp LLCs, largely due to the S corporation shareholder eligibility requirements.[28] For state law corporations, a shareholder's creditor can potentially foreclose and obtain full ownership of the shareholder's stock. At a minimum, this gives the creditor a potentially unwanted voice in shareholder actions[29] and a right to corporate information.[30] If the debtor shareholder is a controlling shareholder, this may turn control of the corporation over to the creditor, who would then have access to the corporation's assets and/or value. Even if the debtor shareholder of an S corporation does not have a controlling interest, the creditor has enormous leverage against the S corporation and its other shareholders because the creditor is typically not bound by the S corporation's shareholder agreement, and the creditor can threaten the corporation with termination of its S status through transfer to an ineligible shareholder.[31]

By comparison, depending on the state of formation, an LLC member's creditor has remedies that are neither as useful to the creditor nor as problematic to the LLC or its remaining members.

Every state offers an LLC member's judgment creditor the right to obtain a charging order (or the equivalent) which acts as a lien against the membership interest entitling the creditor to the debtor member's membership distributions, when or if made, until the debt is satisfied, but no other membership rights like management, voting or even informational rights.[32] Some states also specifically allow a judgment creditor to seek foreclosure on the debtor member's interest[33], while others specifically do not[34], and still others, like Oregon, are either silent or unclear whether foreclosure is available.[35] A charging order is a very weak remedy, since it gives the creditor no voice in the LLC's votes or management, no right to compel the distributions the creditor is after, and no ability to even see the LLC's financial statements. Importantly, it also does not constitute a transfer of the member's interest, so does not terminate the LLC's S election if the creditor (or its transferee) were an ineligible shareholder.[36]

A foreclosure, if available, treats the creditor (or the purchaser in foreclosure) as an assignee, which suffers some of the same shortcomings as a charging order from the creditor's point of view. That is, an assignee receives the transferee member's rights to distributions from the LLC, but no management, voting, informational or other membership rights.[37] However, the specter of a foreclosure does give the creditor the same bargaining chip possessed by the creditor of a minority S corporation shareholder: the threat of terminating the S election through a transfer of stock to an ineligible shareholder.[38] Thus, as in the state law corporation, the creditor might be able to force a favorable sale of its debt (or the foreclosed LLC interest) to the LLC or the other members. However, as indicated, assignment is, at best, an uncertain remedy in Oregon, and this problem can be avoided altogether if the LLC is formed in a state statutorily denying foreclosure as a remedy, like Delaware, Nevada or Alaska.

Assuming a foreclosure occurs, and the purchaser in foreclosure is an eligible S corporation shareholder, the purchaser/assignee might be in a potential position to receive phantom income (i.e., allocations of the LLC interest's share of taxable income without distributions to pay the resulting tax).[39] While some argue this would give the debtor member leverage to force the creditor into a debtor friendly settlement, this seems unrealistic in the S-Corp LLC. First, the ability to foreclose enhances the creditor's bargaining position by raising the threat of terminating the S election, as discussed above. Also, given the pro-rata distribution requirements of the S corporation's single class of stock rules[40], the remaining members would have to put themselves in a similar situation by foregoing their own distributions, which they may be unwilling to do. A somewhat risky alternative action would be to substantially raise salaries of remaining members, but that solution may carry with it unwelcome employment tax side effects.[41]

All bets are off, however, if the LLC has only one member and/or the debtor member is the subject of a bankruptcy proceeding. *In re Albright*[42], a Colorado bankruptcy case, held the Colorado charging order statute was meant to protect a non-debtor member's LLC investment from the debtor member's creditors, but is inappropriate in the context of a single-member LLC where there are no non-debtor members to protect. It therefore allowed assignment of the debtor's single-member membership interest to the creditor as a substituted member, not an assignee, giving the creditor full membership control of the LLC.[43] The Arizona bankruptcy case, *In re Ehmann*[44], held that a bankrupt member in a family LLC held a passive interest without further obligations to the LLC, making the interest taken by the trustee in bankruptcy a non-executory contract, allowing the trustee to step into the bankrupt member's shoes as a full member under Bankruptcy Code § 541(c)(1), notwithstanding the contrary provisions of the LLC's operating agreement and Arizona state law.[45] However, a different answer should result under Bankruptcy Code § 365(c)(1)(A) where the bankrupt member has meaningful unfulfilled service, capital or other responsibilities under the LLC's operating agreement, making the bankrupt member's membership interest an executory contract, and allowing the state charging order statute to control.[46]

Another area in which an LLC is superior to a state law corporation is flexibility. For example, in an Oregon corporation: there must be formal certification of shares; management must be placed in a board of directors; there is the necessity of a formal annual meeting; directors must be reelected or replaced at least every three years; director actions without a meeting must be unanimous; notice requirements must be met for any shareholder or director meeting or action without a meeting; quorums are mandated for shareholder action; director approval is required for certain actions (e.g., mergers and sale of substantially all the corporation's assets); dissenters' rights exist for dissenting shareholders in significant transactions (e.g., mergers, share exchanges, sales of substantially all corporate assets), etc. By contrast, Oregon LLCs are intentionally less formal. There are no required certificated ownership interests. Management can be by members or managers. Managers serve until they are removed or resign. There are no formal meeting requirements for either members or managers. Members or managers may act without a meeting by simple majority (or less, if the LLC's operating agreement provides). Merger approval may be by member vote only. There are no dissenters' rights.[47]

There are yet other differences of note between state law corporations and LLCs. One example includes federal securities laws, where corporate stock is a security by definition[48], while un-certificated LLC interests only become securities if they are "investment contracts" under the so-called "Howey" test.[49] Thus, e.g., member-managed LLCs without passive investor members may well avoid being securities under the 1933 Securities Act and/or state securities laws. There are also a number of states that may tax LLCs and corporations differently, and those differences should be explored and, where appropriate, exploited by entities doing business in those states.

Formation and Operational Issues

Treatment of an LLC as a corporation seems easy enough, check the box on a Form 8832 to be treated as a corporation and file a Form 2553 to be treated as an S corporation. However, in the case of an LLC with more than one member, an S corporation poses some problematic formation and operational issues that could be a trap for the unwary accountant or attorney used to dealing with LLCs as partnerships. Again, a full discussion of the formation and operational differences between LLCs taxed as S corporations and those taxed as partnerships is beyond this article's intended scope. However, a few points are certainly worthy of note. The S corporation election could be inadvertently terminated if an unsuspecting practitioner utilizes some of the representative flexibilities associated with an LLC taxed as a partnership. For example, except for differing voting rights, S corporations may only have one class of stock.[50] An LLC taxed as a partnership may allocate the bundle of ownership rights of the LLC's members in various ways that would jeopardize the one class of stock requirement of an S corporation. In an S corporation LLC, there can be no special allocations, no distribution preferences or shifts, and no non-pro rata member distributions to name just a few tools available to an LLC taxed as a partnership. Interests issued for services must be handled very carefully to avoid unexpected taxation and/or characterization issues to the service member and the other members, as well. Practitioners should draft an operating agreement for an LLC taxed as an S corporation very differently than one drafted for an LLC taxed as a partnership. The operating agreement should conspicuously note that LLC is an S corporation for tax purposes. It should include

various tax-driven provisions typically found in S corporation shareholder agreements, such as provisions prohibiting, negating and imposing liability for transfers of interests to ineligible shareholders, provisions allocating income or loss among members in the case of mid-year transfers or redemptions of interests (especially in the case of a deceased shareholder's insurance-funded redemption), provisions whether a majority (or super majority) of shares can require certain elections (such as termination of the S election, an IRC § 1338(h)(10) election, and the like), etc.[51]

Compensation to members is another area where the S corporation LLC operates differently than an LLC taxed as an NCTE. A member's payment for services rendered to an LLC taxed as a partnership can take the form of either a member's distribution from the member's allocable share of the LLC's taxable income or a guaranteed payment. A sole proprietor's compensation for services will derive from the single-member LLC's taxable income. In each of those cases, the taxable income and/or the guaranteed payment are all subject to the self-employment rules of IRC §§ 1401, et. seq. In the case of a partnership, these amounts are reported on a Schedule K-1 to the LLC's Form 1060, and in the case of a sole proprietorship, they are reported on the Schedule C to the sole proprietor's Form 1040. In each case, members may need to file a Form SE with their Forms 1040.[52] However, an LLC taxed as an S corporation must treat a member the same as any non-member employee receiving compensation, preparing appropriate payroll reports and properly withholding income and employment taxes. The member receives a W-2 reporting his or her earnings for services rendered to the S corporation LLC.

The practitioner should be prepared to take on the additional drafting and counseling tasks as well as advising the client of the likely increased formational costs stemming from an election to treat an LLC as an S corporation. Clients and accountants should also be advised (preferably in writing) of these and other relevant issues in an attempt to prevent later operational changes that could endanger the S election or result in tax surprises to the members.

Summary

At least two distinguished authors have concluded that S corporations organized as state law LLCs are "a solution in search of a problem".[53] I respectfully disagree. I acknowledge that few newly formed entities should choose S corporation tax treatment over that of an NCTE LLC.[54] Still, those authors seem to ignore the large number of existing corporations (C or S) seeking or already enjoying flow-through tax treatment but which can not afford the liquidation tax cost of becoming an NCTE, and there will still be the occasional newly formed business entity which, rightly or wrongly, chooses the S corporation mode. Further, even Rutledge and Simmons grudgingly acknowledge the flexibilities and outside-in protections LLCs enjoy over state law corporations. As such, this author concludes that, while they may not be the norm, there is a limited class of entities for which the S Corporation LLC may be an appropriate choice of entity.

Endnotes

1 Apologies to Ken Kesey.

2 Exceptions include S corporations with a prior C corporation history that fall prey to either the built-in-gains tax of IRC § 1374 or the excess passive investment income tax of IRC § 1375.

3 For a brief, readable explanation of some, but not all, of the most important differences, see Pace, *Debunking the Notion that S Corporations are Taxed 'Just Like' Partnerships*, 9 BTE 4 (July/August 2007).

4 Treas. Reg. § 301.7701-3(a).

5 See, e.g., the conversion provisions of ORS 60.472 and 63.470.

6 In this regard, it should be noted that, in 2005, there were approximately 5.9 million corporate tax filings (which amount includes 2.25 million C corporations and 3.65 million S corporations) compared to 2.65 million partnership tax filings. By 2013, the projections are 7.2 million corporate tax filings (which amount will include 5.2 million S corporations and 2.0 million C corporations) compared to 3.9 million partnership tax filings. *IRS Research, Analysis and Statistics, Office of Research, Fiscal Year Return Projections for United States: 2006-2013, Document 6292.* In Oregon, as of July, 2008, there were 125,596 corporate filings and 108,544 LLC filings. *Oregon Business* (October 2008).

7 Conversion from C to S status can also be costly (*see, e.g.*, fn. 2 and the LIFO recapture rules of IRC § 1361(d)), but typically that cost can be ameliorated and is imposed over time.

8 See, IRC § 1361(b)(1). No such limitations exist for NCTEs.

9 Compare, IRC §§ 731(a), 752(a) and *Melvin v. Commissioner*, 88 TC 63 (1987) with IRC § 1366(d)(1). See also, Eustice and Kunz, Federal Taxation of S Corporations, & 9.05;

10 Compare, e.g., IRC § 704(b) and Treas. Reg. §§ 1.704-1(b) and 1.704-2 with IRC § 1361(b)(1)(D) and Treas. Reg. § 1.1361-1(l).

11 Compare, IRC § 731 with IRC §§ 301, 311, 331 and 336.

12 See, IRC §§ 734, 743, 754 and 755 which have no comparable Subchapter S provisions.

13 Compare, IRC §§ 731, 736, 741 and 751 with IRC §§ 301, 302, 311, 331 and 336.

14 Eustice & Kunz, *Federal Income Taxation of S Corporations*, ¶15.02[5]. S corporation shareholder distributions also are not subject to self employment taxes. Rev. Rul. 59-221, 1959-1 CB 225. FICA taxes on salary consist of two equal portions, an employee portion paid from withholding the employee's salary and an employer portion, paid as a tax on the employer, each being the sum of 7.65% (i.e., 15.3% in total) for wages up to Social Security wage base, $106,800 in 2009 and 2010 and 1.45% (i.e., 2.9% in

total) on any wages in excess of that wage base. IRC §§ 3101(a) and (b) and 3111(a) and (b).

15 To date, the IRS seems to attack only the most extreme cases where little or no amount is allocated to salary, and virtually all the net business income is treated as shareholder distributions exempt from FICA. *See*, *e.g.*, cases cited at Eustice & Kunz, *supra* n. 14 at ¶15.02[5][b] fn. 80.

16 IRC § 1402(a). Self-employment taxes are imposed upon a self-employed worker in a single amount equal to the employer and employee portions of FICA taxes, i.e., 15.3% up to the Social Security base and 2.9% on any excess. IRC §§ 1401(a) and (b).

17 IRC § 1402(a)(1).

18 IRC § 1402(a)(2).

19 IRC § 1402(a)(3).

20 IRC § 1402(a)(13).

21 Prop. Treas. Reg. § 1.1402-2(h).

22 Taxpayer Relief Act of 1997, Pub. L. No. 105-34, Section 935 (1997).

23 Note that both Treasury and Congress are aware of the employment tax avoidance potential of the current S corporation rules, and proposals to amend the law are periodically advanced.

24 Compare, *West Coast Marketing Corp. v. Comm'r*, 46 TC 32 (1966) (finding a prearranged plan) and Rev. Rul. 70-140, 1970-1 CB 73 (same), with *Vest v. Comm'r*, 47 TC 128 (1971), aff'd on this issue, 481 F.2d 238 (5th Cir. 1973), reh. denied, 481 F.2d 1404 (5th Cir. 1973), cert. denied, 414 US 1092 (1973) (finding no plan and a valid reorganization) and *Weikel v. Comm'r*, TC Memo 1986-58 (same).

25 IRC § 357(c).

26 Nonexclusive examples include the potential availability of up to $100,000 of ordinary loss treatment on S corporation stock under IRC § 1244, the insolvency exception to recognition of cancellation of indebtedness income being tested at the entity level for S corporations (IRC § 108(d)(7)) rather than the owner level for NCTEs (IRC §§ 108(a)(1)(B) and 108(d)(6)) and health insurance premiums are excluded from wages for S corporation employees under IRC § 3121(a) but not from self-employment income for NCTE owners under IRC § 1401(a).

27 See, ORS 60.15(2) and ORS 63.165(1).

28 IRC § 1361(b)(1).

29 This assumes the debtor shareholder's stock has voting rights. ORS 60.214(1).

30 ORS 60.744 and 60.777.

31 IRC § 1362(d)(2).

32 E.g., ORS 63.259.

33 E.g., Ill. Compiled Statutes Ch. 805, § 703, and RULLCA § 503(c).

34 E.g., Alaska Statutes 10.50.380(c); Del. Code § 18-703; Nev. Rev. Statutes 86.401.

35 ORS 63.259.

36 E.g., ORS 63.259 provides the charging order is a charge against, not a transfer of, the membership interest, and although it says the creditor has the rights of an assignee, it clearly does not constitute an actual assignment of the debtor member's interest. Del. Code § 18-703(b) makes it clear the charging order is no more than a lien on the judgment debtor's LLC interest.

37 E.g., ORS 63.249(3).

38 The author is not aware of any cases or rulings on point; however, the assignee should be treated as the member for tax purposes. E.g., *Evans v. Comm'r*, 447 F.2d 547 (7th Cir. 1971); Rev. Rul. 77-137, 1977-1 CB 178. This would be particularly likely in Oregon if the LLC's operating agreement did not specifically countermand ORS 63.249(5) which terminates the assignor's membership interest.

39 Id.

40 See, Treas. Reg. § 1.1361-1(l)(2).

41 See, Footnotes 14 and 15 and the accompanying text.

42 291 BR 538 (Bankr. D. Colo. 2003).

43 Id. Note that Colorado appears to permit a creditor's foreclosure of the debtor member's LLC interest, but as in every other state allowing foreclosures, only as an assignee. Colo. Rev. Stat. § 7-80-703 (2008). For a different result in an analogous situation, compare, *Evans v. Galardi*, 546 F.2d 313 (Cal. 1976) (court applies charging order even though each member liable to the same creditor, so there were no non-debtor members).

44 334 BR 437 (Bankr. D. Ariz. 2005), withdrawn, *In re Ehmann*, 2006 WL 173688 (Bankr. D. Ariz. 1/25/2006) (withdrawn when creditor settled with LLC on favorable terms because, in part, the LLC's general manager, a tax lawyer who proposed family LLCs for his clients, wanted to eliminate the case's precedential effect).

45 Under Ariz. Rev. Stat. Ann. § 29.655 (1998), a judgment creditor's sole remedy against a debtor member is a charging order with the rights of an assignee.

46 E.g., *Broyhill v. DeLuca*, 194 BR 65 (Bankr. E.D. Va. 1996). For a good general discussion on charging orders and foreclosures, *see*, Stein, *Building Stumbling Blocks, A Practical Take on Charging Orders*, 8 BET 5 (Sept./Oct. 2006).

47 Compare, generally ORS Chapter 60 with ORS Chapter 63.

48 *Landreth Timber Co. v. Landreth*, 471 US 681 (1985).

49 Named for *S.E.C. v. Howey*, 328 US 293 (1946).

50 IRC § 1361(b)(1)(D). See, generally, Treas. Reg. § 1.1361-1(l).

51 For a good discussion of this area, see, Looney and Levitt, *Shareholder Agreements for Closely Held Corporations*, 5 BET 1 (Jan/Feb 2003). These provisions are, of course, in addition to entity-specific provisions in operating agreements dealing with management, transfers of interests, exit strategies, entity dissolution, etc.

52 Note that, if the LLC's business is rental real estate, the proper form will be Schedule E to the Form 1040, and a Schedule SE may not be necessary.

53 Rutledge & Simmons II, *S-Corp. LLCs - Planning Opportunity or Solution in Search of a Problem?* (Publication unknown, and hereafter, "Rutledge and Simmons").

54 Rutledge and Simmons also worry about a potential disconnect between the pro-rata per-share distributional requirements of the S corporation one-class of stock requirements and the default LLC liquidation statute (e.g., ORS 63.625(3)) which requires that, except as otherwise provided in the LLC's operating agreement, liquidation distributions to members first return unreturned capital contributions with any excess being distributed according to profits. This might, indeed, be a trap for the unwary, e.g., where capital contributions are not pro-rata according to ownership percentages. However, as the authors acknowledge, any such disconnect can be cured through proper drafting of the LLC's operating agreement.

A Sad Reminder About Responsible Person Liability

By David C. Culpepper

A recent US District Court decision tells a sad but true story about responsible person liability for unpaid payroll taxes.

IRC §6672(a) allows the IRS to collect a penalty equal to 100% of payroll taxes that an employer does not pay from a "responsible person," namely a person who is responsible for collecting, accounting for, and paying over the employer's payroll taxes, and who willfully fails to perform this responsibility.

In *McCloskey v. US*, 104 AFTR 2d ¶2009-5376 (D PA, September 15, 2009), Mr. McCloskey was the president and sole shareholder of a corporation. He delegated tax return functions to the corporation's CFO. The CFO embezzled over $800,000 and failed to report or pay withholding taxes over a four year period. At the end of this period, Mr. McCloskey learned about the embezzlement (but not the amount) only when the CFO resigned in September 2004.

Later in September 2004, the corporation received notice from the IRS that its payroll returns had not been filed for 19 quarters. Once Mr. McCloskey became aware of the magnitude of the CFO's embezzlement, he began winding down the corporation's business by paying the corporation's creditors and its employees (including himself) at a reduced rate. However, he did not pay the IRS.

Mr. McCloskey sold the corporation's inventory and used the proceeds to pay a personally secured bank loan. Mr. McCloskey signed and filed the back payroll returns, but did not pay the back payroll taxes.

The IRS assessed Mr. McCloskey for the 100% responsible person penalty. He paid a portion of the amounts due and then sued in District Court for a refund. He argued that although he was in fact a responsible person within the meaning of IRC §6672(a), he did not *willfully* fail to pay over the payroll taxes. He established that prior to the CFO's resignation, he did not know and had no reason to suspect the theft or the failure to pay payroll taxes. Mr. McCloskey further argued that after he received the resignation letter, it took him several months to figure out the amounts that had not been paid. By that time, all of the corporation's funds had been expended.

Mr. McCloskey's sad tale and arguments fell on deaf ears. The District Court held Mr. McCloskey liable for the full amount of the penalty. The Court noted that when Mr. McCloskey first became aware of the CFO's misconduct, he knew that the corporation's tax liability could be substantial. Nonetheless, he thereafter made a calculated decision to pay other creditors before determining the full amount owed to IRS.

The court rejected Mr. McCloskey's argument that he did not willfully fail to pay the taxes because he did all that he could to see that they were paid after he knew the exact amount of the deficiencies. The Court concluded that a president and sole shareholder could not delegate his duty to make sure that the taxes were actually being remitted. The court held that willfulness is shown where a responsible person acts with reckless disregard of whether withholding taxes have been paid. Establishing that one should have known and could have easily ascertained whether trust taxes were being turned over to IRS was enough to establish reckless disregard.

Taxation of Business Owned Life Insurance: The Trap is Set

*By Joshua E. Husbands**

Life insurance has long been accepted and regarded as a valuable tool in planning for business contingencies and succession. One of the key benefits to business planning with life insurance has always been that life insurance proceeds have typically been received on an income tax free basis. However, legislation enacted in 2006 now causes life insurance proceeds received by an employer on the life of an employee to be taxable income to the employer unless certain requirements are met. This is a monumental shift in business succession planning, but has received surprisingly little fanfare since the legislation was enacted. It is very important that business owners and their advisors understand and comply with the requirements of IRC Section 101(j) ("Section 101(j)").

Business planning with life insurance typically involves insuring the lives of key executives. The insurance purchased on the life of the executive is used to provide liquidity to better weather the bumpy transition that sometimes follows the death of a particularly valuable employee. This strategy is regularly referred to as "key person" life insurance planning. Also common is the use of life insurance to provide liquidity for the purchase by the business of ownership interests from deceased, retired or disabled business owners. In some instances, rather than having the business purchase the ownership interest, the other owners of the business will purchase the ownership interest of a deceased, disabled or retiring co-owner by using life insurance owned personally by the purchasing owners to fund the buyout. This type of arrangement is commonly referred to as a "cross purchase" arrangement.

In addition to these types of acknowledged and legitimate practices, a few larger companies have in some instances, such as those discussed in the Wal-Mart, Winn-Dixie and Camelot Music cases[2], entered into the questionable practice of purchasing life insurance on the lives of rank-and-file, non-key employees. In some cases, the employees are not aware that the life insurance coverage is in place. In other particularly egregious circumstances, the employee may not be aware of the coverage and it is maintained in effect even after the employee no longer works for the business. These arrangements are often referred to as "janitor policies" and often raise the ire of regulators and elected officials. As a response to these perceived abuses, the Pension Protection Act of 2006 ("PPA") was enacted, under which new Section 101(j) was added to the Internal Revenue Code. As is often the case with legislation aimed at curtailing abuse, Section 101(j) not only serves to prevent arrangements that involve the use of so-called janitor policies, but it also creates abundant danger for potentially devastating and unintended tax consequences to the unwitting business owner who is seeking to employ life insurance planning in a completely well intentioned and straight forward fashion.

Since the enactment of the PPA, employer-owned life insurance policies issued after August 17, 2006, for whatever purpose, will be subject to a denial of the Section 101(a) exclusion from income of death benefits (in excess of the employer's basis in the policy) unless they meet fairly restrictive requirements *before the policy is issued*. If the requirements of Section 101(j) are not complied with before the issuance of the policy, the proceeds are forever tainted and will be received tax free only if the policy is surrendered and a new one issued in a manner compliant with Section 101(j) before the death of the insured. This can cause considerable difficulty if the health of the insured has declined since the policy was originally issued.

If the life insurance proceeds are paid to the employer, several requirements must be met to avoid the inclusion rule of Section 101(j). First, the insurance policy must be issued on a director, highly compensated employee, highly compensated individual, or an individual who was an employee at any time during the 12 months before his or her death. A highly compensated employee is defined as an employee who owned 5% or more of the business in the current or preceding year or was paid at least $95,000 (adjusted for inflation) in the preceding year. A highly compensated individual is defined as an individual who is one of the five highest paid officers of the business, owns at least 10% of the business (whether or not an employee), or is among the highest paid 35% of all employees. In addition, very specific notice and consent requirements must be met before the issuance of the policy. These requirements are that the employee:

Is notified in writing that the employer intends to insure his or her life and the maximum face amount for which the employee could be insured at the time the policy was issued;

Provides written consent to being insured and that the coverage may continue after the insured terminates employment; and

Is informed in writing that the employer will be a beneficiary under the policy upon the employee's death.

Even if the issuance of a life insurance policy to the employer antedates the adoption of the PPA, the policy may still fall within the scope of Section 101(j) if there is a material modification to the policy after August 17, 2006, such as a significant increase in death benefit that results in treating the modified policy as newly issued.

There is an important estate and succession planning exception available under IRC Section 101(j)(2)(B) for amounts paid to family members, trusts for the benefit of family members and the estate of the insured, or if the policy proceeds are used by the business to purchase an ownership interest of the insured from one of those parties. These policies would be owned by the employer, but the proceeds would either be paid to the family member, trust or estate directly as the named beneficiary of the policy, or the proceeds would be used by the business to purchase the ownership interest of the insured. There is little to no guidance available on this issue, so it is probably prudent to mandate the use of the proceeds to purchase the ownership interest in a buy-sell agreement executed by the business owner at the time the policy is issued to the employer in order to avoid any possibility of subjecting the proceeds to taxation under Section 101(j). The notice and consent requirements still must be met to qualify for this estate planning exception.

Section 101(j) has recently become even more relevant to employers because the regulations for IRC 6039I have been made final. Under IRC 6039I, an employer must annually file with the IRS for all tax years ending after November 13, 2007 (for policies subject to IRC 101(j)) a report that lists:

1) the number of employees employed by the employer at the end of each tax year;
2) the number of employees insured by the employer at the end of each tax year;
3) the total amount of employee life insurance in force at the end of each tax year;
4) the name, address and taxpayer identification number of the employer and the type of business it is in;
5) a representation that the employer has valid consents of all insured employees as required by Section 101(j).

The requirements of Section 101(j) are mechanical and unyielding. Even owners of a business are subject to these rules if they are also employees of their business. In other words, a business owner who participates directly in applying for and obtaining life insurance on his or her own life will find that the life insurance proceeds are taxable (albeit not until his or her death) if all of the requisite notice and consent requirements of Section 101(j) are not in place prior to issuance of the policy. That seems like an absurd result, but is in fact what will happen if all the requirements of Section 101(j) are not complied with. This type of draconian result strongly suggests that all business owners and their advisors be mindful of the requirements of Section 101(j) when engaging in any life insurance planning for their business.

Endnotes

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2 Atkinson v. Wal-Mart Stores, Inc., 2009 WL 3320322 (C.A. 11 (Fla.)); Winn-Dixie Stores, Inc. and Subsidiaries v. Commissioner of Internal Revenue, 254 F3d 1313 (11th Cir. 2001); Tillman v. Camelot Music, Inc., 408 F3d 1300 (10th Cir. 2005).

New Washington Law Imposes Sales Tax on Digital Goods

By Daniel S. Lapour[1]

Washington recently expanded its sales tax base by enacting legislation that imposes sales or use tax on all digital products.[2] Beginning July 26, 2009, everything from downloaded movies and music to streaming online games is subject to sales or use tax. The purpose of this article is to provide an overview of the new Washington digital products law.

The new law defines "digital products" as "digital goods and digital automated services."[3] A "digital good" is defined as "sounds, images, data, facts, or information, or any combination thereof, transferred electronically."[4] A digital good includes, but is not limited to, electronically transferred digital audio-visual works, digital audio works, and digital books and other products transferred electronically.[5]

The legislation defines "digital automated service" as "any service transferred electronically that uses one or more software applications."[6] Examples include search engine services, online gaming subscription services, and online digital photography editing services.[7]

In addition to imposing tax on the digital products defined above, the new law extends the sales and use tax to transactions involving "digital codes."[8] A "digital code" provides a purchaser with the right to obtain one or more digital goods and/or automated services.[9] For example, a person that purchases a digital code that allows the electronic delivery of a song is subject to sales tax because the song is a "digital audio work" that is subject to tax.[10] A digital code does not include a code that represents a stored monetary value, or redeemable gift card or gift certificate.[11]

Certain transactions are exempt from retail sales and use tax, including purchases for resale and purchases where the digital product or code becomes an ingredient or component of a new product to be sold.[12] Additionally, transactions in which a digital product or code is made available free of charge are exempt from sales and use tax.[13]

Furthermore, sales and use tax does not apply to sales of "standard digital information" to a business, where the information is purchased solely for business purposes.[14] "Standard digital information" means a digital good consisting primarily of data, facts, or information, or any combination thereof, not generated or compiled for a specific client or customer.[15]

The good news for sellers of digital products is that the new law also changes the application of the business and occupation ("B&O") tax laws with regard to sales of digital products. Sellers of all digital products will now be subject to the lower retailing and wholesaling B&O tax rates.[16] Previously, revenues received from the sale of some digital products were subject to the higher B&O tax rate imposed on "services and other activities."

The new law remains in a state of flux as Washington works to clarify many of the complexities. Recently, on September 4, the Washington Department of Revenue issued two draft excise tax advisories explaining how the new state law creates tax liability for sales of certain digital products and how sales of digital products are sourced.[17] Even with the Department's clarification, which is certainly welcome, there remain many features of the new law that require careful examination by both taxpayers and their advisors.

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Endnotes

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2 H.B. 2075, Laws 2009.

3 Wash. Rev. Code § 82.04.192(7).

4 Wash. Rev. Code § 82.04.192(6)(a).

5 *Id.*

6 Wash. Rev. Code § 82.04.192(3)(a).

7 Wash. Dept. of Rev., Draft Rule 15503 – Taxation of Digital Products.

8 Wash. Rev. Code § 82.04.050(8)(a).

9 Wash. Rev. Code § 82.04.192(5).

10 Wash. Dept. of Rev., Draft Rule 15503 – Taxation of Digital Products.

11 Wash. Rev. Code § 82.04.192(5).

12 Wash. Rev. Code §§ 82.08.02082, 82.12.02082.

13 *Id.*

14 Wash. Rev. Code §§ 82.08.02087, 82.12.02087.

15 *Id.*

16 Wash. Rev. Code § 82.04.257.

17 The Draft Digital Product Excise Tax Advisories can be found at http://dor.wa.gov/Content/FindALawOrRule/ETA/etatoc9000.aspx.

New Top Marginal Personal Income Tax Rates

CORRECTION NOTICE: There is a misstatement in the article titled "New Income Tax Increases" in the Winter edition of the Taxation Section Newsletter (Volume 13, No. 1). The section under the heading "New Top Marginal Personal Income Tax Rates" on page 7 should read as follows:

During the 2009 legislative session several bills were proposed to increase the top marginal personal income tax rate. These bills generally were substantially similar in that they would have subjected income in excess of a certain amount to a tax rate above the prior top marginal rate of 9%. One proposal, House Bill 2652, in addition to creating a new top marginal personal income tax rate, also would have expanded the scope of the 5% and 7% marginal tax rates and thus would have raised the income threshold to which the 9% marginal rate applied. Ultimately, the legislature passed, and Governor Kulongoski signed into law, House Bill 2649 (Or Laws 2009, ch 746).

This law increases personal income tax rates for single taxpayers with taxable income above $125,000 ($250,000 for taxpayers filing a joint return). For 2009, 2010 and 2011, the law adds a rate of 10.8% for a single person with respect to taxable income over $125,000 but not over $250,000 (for joint returns, $250,000 and $500,000, respectively) and a rate of 11% for a single person with respect to taxable income over $250,000 (for joint returns, $500,000).[1] For 2012 and thereafter, the 10.8% rate is reduced to 9.9% and the 11% rate is eliminated.[2] Accordingly, after 2011, the law imposes a 9.9% marginal rate on income over $125,000 (for joint returns, $250,000). Unlike the lower rate brackets, the new brackets created by the law are not indexed for inflation.[3]

Endnotes

1 *See* Or Laws 2009, ch 746, §§ 1, 7(1).

2 *See* Or Laws 2009, ch 746, §§ 2, 7(2).

3 *See* Or Laws 2009, ch 746, § 1.

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