REPORT #763

TAX SECTION

New York State Bar Association

Draft LLC Tax Legislation

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Re: Draft LLC Tax Legislation

Dear Deborah and Brien:

New York State currently is considering the enactment of legislation that would create a New York Limited Liability Company ("LLC") and recognize LLCs formed in other states that do business in New York State. The use of the LLC vehicle in New York will depend very much on New York's tax treatment of the LLC. In testimony on December 4, 1992 and in an Outline dated January 27, 1993 the Tax Section's Task Force on LLCs provided extensive commentary on the LLC vehicle and on various forms of revenue raising New York might consider. We reiterate the concerns already expressed by our Task Force -- New York should not adopt tax rules for LLCs that are overly complex or that otherwise discourage the use of LLCs in New York.

The LLC is a pass-through vehicle for federal income tax purposes, and therefore creates the possibility of revenue loss to New York if conforming pass-through treatment is adopted for the State. The measure of such revenue loss is quite uncertain, —- however, since it turns on predictions as to future taxpayer response both with respect to existing entities and entities to be created. It is our belief, based on the advice we would render to clients, that the revenue loss would be significantly less than projected by the State. As we discuss further below, our view reflects the belief that the revenue loss from LLCs that "would have been" new C corporations should not be significant as projected, since we would advise our clients (as would most practitioners) to use S corporations or limited partnerships if LLCs were not available.

While we appreciate the concerns that strict federal conformity could produce an unacceptable revenue loss to New York State, the State must also recognize that departures from federal conformity would impose burdens that could significantly erode the utility of the LLC vehicle for New York businesses. The application of a complex new tax system to LLCs would, in our view, seriously compromise the usefulness of LLCs in New York. This could prove to be a general disincentive to conducting business in New York, and in any event would leave New York in the undesirable position of having recognized the LLC vehicle in a manner that renders the LLC of limited practical utility. Undue conservatism as to revenue loss, which then leads to burdensome taxes on the LLC or its members, could therefore be costly to the New York economy.

Discussed below are our concerns about the revenue estimates used by the State. That discussion is followed by a summary of our comments on the Department of Taxation and Finance bill dated March 25, 1993 (the "DTF Bill"). The DTF Bill sets forth a proposal for imposing an entity-level tax on the income of LLCs. A copy of the DTF Bill also is enclosed and reflects technical comments of the Tax Section's Task Force on LLCs.

This letter also sets forth our comments on an alternative legislative proposal prepared by the staff of the Assembly Ways & Means Committee. This alternative would impose an additional member-level tax on the net income derived by individual members of an LLC.

We also comment on Senator Daly's Bill (S.27-B), which includes no specific provisions for the taxation of LLCs, and imposes various fees.

We continue to believe that the imposition of fees on LLCs or their members would be the most desirable revenue raising approach. As discussed in section E, below, we believe this approach certainly merits further consideration, particularly if more realistic (in our view) revenue estimates are applied. A fee-based system could eliminate many of the complexities and burdensome technical inquiries presented under the income tax approaches. Moreover, given the number of LLCs and LLC members projected by the State, it would seem possible to design a system of fees low enough so as not to discourage the use of the LLC vehicle in New York.

Finally, there has been discussion of the possible imposition of the requirement that LLCs obtain tax clearance certificates prior to effecting a merger. If an entity-level tax is imposed on LLCs, we urge the State not to also impose this requirement. There are currently considerable delays in obtaining tax clearance certificates for corporations, and often these delays cause timing problems for New York corporations. It would be most undesirable to extend the present system to LLCs.

A. Comments on Estimated Revenue Loss.

The Administration projects that there will be a $40 million annual revenue loss from new businesses principally owned by individuals that would, absent LLC legislation, be formed as closely-held C corporations. We understand that the bulk of this projected revenue loss derives from lost corporate income taxes. Thus, the Administration's model projects that individually-owned entities with annual New York taxable income of approximately $400 million would, in the absence of New York LLC legislation, be formed and operate in New York as C corporations. Moreover, this group of enterprises is apparently less than half of the total population of closely-held businesses projected to be formed as C corporations, bringing the total projected New York taxable income of this group to a considerably larger amount.

This projection is perplexing to us. One possible explanation for this level of projected loss is the fact that the statistical sample apparently was based on corporate tax formations dating back to 1985, the era before General Utilities repeal. The structure of the income tax law has changed fundamentally since the 1986 Tax Reform Act, including changes that have facilitated greater use of S corporations and limited partnerships. It would be unreliable to project future choice of entity decisions based on decisions made prior to the impact of these changes. Indeed, the federal landscape appears to be changing again, with the proposed changes in federal corporate and individual tax rates and the proposed introduction of a capital gain exclusion for small business stock. If these changes occur, the use of LLC may be relatively less attractive than was assumed when making the State's LLC revenue projections.

In endeavoring to understand the $4 0 million projected loss we conferred with the accounting industry representatives with whom the Administration worked in developing the revenue projections. We were advised, however, that the private sector estimators focused almost entirely on issues relating to the projected conversions of existing corporations into LLCs (where the resultant revenue loss is now estimated to be $20 million). Apparently, the private sector experts did not have much input into the projections regarding newly formed enterprises, and thus were not able to offer any insight regarding this aspect of the projections.

Assuming that there is $400 million of annual New York taxable income to be derived from individually-owned enterprises suitable for formation as LLCs, our experience as tax advisers suggests that it is not likely this enormous volume of profitable business would currently choose to form as fully taxable C corporations. The combined burden of federal income tax and New York State and City franchise taxes already operate as strong disincentives to the use of C corporations for profitable individually-owned businesses. Partnerships and S corporations are much more tax efficient. It is therefore our sense, albeit not statistically or scientifically derived, that while the LLC will furnish a useful and important new business form, it should not alter the choice-of-entity analysis as dramatically as this projection indicates.

B. Comments on the DTF Bill.

During the week of May 31, 1993, a representative of the Tax Section's Task Force on LLCs reviewed with staff attorneys at the Department of Taxation and Finance various substantive and technical issues raised by the DTF Bill. There are four areas of the DTF Bill, described below, which are of greatest concern to us.

Moreover, we continue to have fundamental questions and significant concerns about the complexity of the entity-level tax proposed under the DTF Bill. We emphasize that the complexities inherent in this kind of approach cannot be eliminated simply by making technical refinements to the DTF Bill.

With respect to technical issues in the DTF Bill, the four principal areas of concern are as follows.

1. Taxable Base. The DTF Bill requires an LLC, which is a partnership for federal tax purposes, to recompute income “as if it were a C corporation.” This raises numerous technical problems. There are dozens of respects in which the computation of partnership income can differ from the computation of corporate income.[1] We believe that any entity-level tax on LLCs should hew as closely as possible to computations the LLC will already be making as a federal partnership, and should not impose a separate set of New York rules.

[1] Examples include the application of passive loss rules, at risk rules, and other limitations on deductions; the dividends received deduction available to corporations; the computation and treatment of cancellation of indebtedness income; and the application of different allocation and apportionment formulae under New York tax law.

We understand that the DTF Bill has been redrafted to change the base to something more closely conforming to the computation of partnership income for federal income tax purposes. We are interested in reviewing the new approach, and evaluating the New York modifications, apportionments and other adjustments made to LLC income.

2. Measuring Members[2] Capital. The DTF Bill essentially was designed to allow deductions for profits that represent a “return on labor” while capturing tax on profits that are a “return on capital.” This approach is theoretically interesting and creative, but raises a number of complexities. One such problem is the Bill's proposal to measure capital by reference to the members' outside tax bases for their LLC interests. Outside basis includes partnership debt and thus does not function well as a measure of partners' capital. We understand that the DTF Bill has now been redrafted to exclude debt, but there still are a number of problems with using members' outside bases to compute partnership capital. For example:

(i) Transfers of LLC interests and deaths of individual members will cause shifts in outside basis. The LLC may not be aware of, nor able to quantify, these changes. Moreover, if the entity's New York tax burden fluctuates based on member-level transfers and deaths, this may give rise to distortions in the members' economic relationships.

(ii) Outside basis may bear no relationship to the value of partnership assets or to other members' outside bases. As a result, the tax burden on two otherwise equal and identical entities can be vastly different where one entity is “old and cold” and has significant appreciation in the value of its assets while the other entity is newly acquired at fair market value. Similarly, within an LLC the tax burden could be peculiarly imposed, for example where one member has contributed low-basis property and another has contributed cash.

(iii) Many businesses do not distribute the year's earnings until after the close of the taxable year. Thus, outside basis and capital accounts are “overstated” at year end, and at the first day of the next taxable year, because members' draws have not yet been distributed.

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[2] An analogous issue was considered in Revenue Ruling 92-29, 1992-1 Cum. Bull. 20, which addressed the deductibility of costs incurred for the preparation of an individual's income tax return that included both business and nonbusiness income, and for resolving tax deficiencies relating to business income from the individual's sole proprietorship.

Rather than looking at outside basis one might measure capital by reference to the partnership's inside basis or book capital. This approach would not, however, eliminate all of the problems described above. In particular, the disparate treatment of "old" and "new" businesses would continue, and while requiring annual valuations of LLC assets might address this problem, such an approach would be enormously burdensome.

3. Material Participation. The DTF Bill refers to the concept of "material participation," but employs only one of the federal income tax tests of material participation -- the 500 hour test. This test does not work well in any number of circumstances, including:

(i) Businesses that require fewer than 500 hours per year from any member or employee.

(ii) Lines of business that are conducted through separate LLCs, such as a restaurant chain in which each restaurant is in a separate LLC and the owners, while spending more than 500 hours in the aggregate, do not spend 500 hours on any particular LLC.

(iii) Businesses in which the income earned from services may not be realized until a year subsequent to the year in which services are performed. An example of this is the case of retiring service partners, whose firms may not realize income from their work until subsequent taxable years.

Some of these problems might be addressed by expanding the New York test to incorporate the federal definitions of "material participation" and of "activity." One would, however, still face increased complexities, for example if such rules must be applied to corporations not otherwise concerned with the application of the federal passive loss rules.

4. Credits. To avoid imposing additional tax on corporate members of LLCs, the DTF Bill provides for credits against the Article 9-A franchise tax on corporate income. These credits will not, however, completely eliminate the duplicative taxation of corporate LLC members. For example:

(i) With several tiers of entities, (such as an LLC owned by a partnership with corporate partners), the credit may be "lost" in one of the interim tiers and will not be available to the ultimate corporate member.

(ii) Without a credit carry-forward credits will be lost in years in which corporate members have net losses, even though the LLC income reduces corporate loss carry-forwards. This problem is illustrated by the Richmond Constructors case.

(iii) If the credit is available only against the Article 9-A tax on ENI, corporations paying tax on other bases will effectively bear both the existing franchise taxes and the new LLC tax.

If the credit mechanism does not entirely eliminate the additional LLC tax burden, corporations will be discouraged from using LLCs. This does not seem advisable, nor does it seem necessary given that the revenue slippage identified by the Administration relates to individual taxpayers.

C. Comments on the Ways & Means Proposal.

1. Taxable Base. The Ways & Means proposal would impose tax "on the sum of all subchapter K limited liability company items of income, gain, loss and deductions...." While we understand the concept, the language itself is confusing. We would suggest that the tax be imposed on "the net income derived from" subchapter K limited liability companies.

In addition to the differences in taxpayer identity (LLC vs. member) the DTF Bill and the Ways & Means proposal differ significantly in the treatment of service businesses. The DTF Bill is designed to exempt large portions of service sector income from the LLC tax base, imposing instead a higher rate of tax on capital-intensive enterprises. By contrast, the Ways & Means proposal would subject all kinds of businesses to the same tax scheme, and presumably impose an LLC income tax at a considerably lower rate. As discussed below, the imposition of an LLC income tax on service sector businesses heretofore conducted as partnerships will be a real barrier to the use of LLCs by service companies, unless the rate of tax is relatively low.

The draft, and our suggested clarification, raise some additional questions with respect to the base of the proposed tax:

(i) The proposal to impose an additional tax on certain types of income derived from LLCs brings pressure to bear on the characterization of amounts paid to members of an LLC. Two common situations in which this characterization issue will be important are amounts paid as a return on capital, and amounts paid for services rendered. For example, if interest paid to a member is not subject to additional tax but an allocation in payment of a preferred return is subject to additional tax, then the LLC and its members will be inclined to characterize investments as interest bearing loans. Similarly, if guaranteed payments for the use of capital are subject to additional tax, the tax structure would tend to favor debt-financed LLCs over those to which members made capital contributions and earned guaranteed payments.

In the case of guaranteed payments for services, many service firms currently make guaranteed payments to some members; for income tax purposes, these payments are then deducted in computing the net income allocable to other members. If there were no additional tax on guaranteed payments and the deduction for guaranteed payments were still allowed in computing net LLC income, then an LLC could (subject perhaps to a reasonableness standard) compensate the members providing services by making guaranteed payments, without triggering additional tax on those members' compensation for services.

The approach taken with respect to payments made to members for services or for the use of capital is essentially a policy question. The resolution should be clearly analyzed and articulated, and in any event it should be recognized that distinctions made in the application of the tax will affect, and complicate, LLC planning.

(ii) In circumstances where an individual derives taxable income from one LLC but has a net loss from another LLC, it seems appropriate to permit the individual to offset the LLC loss against LLC income and pay additional tax only on the net amount. This should be clarified. By taxing an individual's net income from LLCs, the additional tax would then capture the economic profit derived from LLCs, without placing a premium on form or penalizing individuals who conduct business through more than one LLC entity.

(iii) It also should be clear that the additional tax will allow individuals to carry forward LLC losses from prior years (to the extent a carryforward is otherwise allowed), and to offset those losses against subsequent years1 LLC income.

(iv) Individual LLC members may incur expenses that relate to their interest in the LLC. One likely example is an individual who borrows and invests the proceeds in the LLC. The federal income tax law applies tracing rules to characterize individuals interest expense, and would characterize the above-described interest expense as relating to the LLC. Treas. Reg. §1.163-8T. Query whether a similar rule should apply for purposes of the additional tax.

2. Federal Treatment of the Additional Tax. It is generally to New York's advantage to fashion State taxes in a manner best designed to achieve full federal deductibility. Because of the disallowance of itemized deductions under Code section 68, as well as the individual alternative minimum tax rules, the net effective cost of the additional tax will be higher if the tax is an itemized deduction than if the tax is an “above-the-line” deduction. By imposing tax at the member level rather than the entity level, the question of the characterization of the additional tax will be directly

presented. Because the tax imposed under the proposal is specifically tied to the conduct of business in LLC form, in cases where the LLC is engaged in a trade or business the tax imposed under the proposal may qualify as an above-the-line deduction.[2] However, the imposition of tax at the member level does raise an issue not presented by an entity-level tax.

3. Rate of Tax. Unlike the DTF Bill, the tax imposed under the Ways & Means proposal does not distinguish between service firms and capital-intensive firms. This eliminates a significant aspect of the complexity found in the DTF Bill. However, if the rate were as high as the 2% rate of tax used in the draft (plus 0.35% under the City unincorporated business tax), there is likely to be considerable resistance to the use of the LLC, particularly in the service sector where business currently is widely conducted in general partnership form.

As noted above, we do not feel New York would be well served by burdensome LLC tax provisions that discourage the use of the LLC vehicle in New York. We understand that the rate actually applied under this kind of proposal would likely be considerably lower than 2%. A lower rate of tax would, we expect, trigger broader use of the LLC; and the greater the use of LLCs the more revenue one would expect to derive from the additional tax.

4. Imposition of Tax at Individual Level. The imposition of an additional tax at the individual level has some advantages and some drawbacks:

(i) In terms of complexity, and in terms of attracting corporate users to the LLC, the proposal's approach avoids the need to compute corporate credits in order to offset the burden of the entity-level tax. This eliminates the possibility that corporate members could pay both LLC tax and franchise taxes. By targeting the tax directly at the perceived source of unacceptable revenue loss -- the rate differential between PIT rates and franchise tax rates -- the proposal eliminates a major source of concern with the DTF Bill.

(ii) The imposition of tax at the member level does require that each individual member of an LLC separately identify his or her New York State source LLC net income. This adds some complexity to the PIT law. The collection of additional tax from LLC members also will require a greater collection effort than would be required with an entity-level tax; and individual-level collection efforts may be less effective, particularly with nonresident individuals, than under an entity-level tax. These administrative problems already exist to some degree with respect to the collection of PIT from members of partnerships and S Corporations, and will similarly exist with respect to the collection of PIT on the income derived by members of LLCs.

D. Comments on Senator Dalv's Bill.

Senator Daly's Bill does not provide for any special New York tax treatment of LLCs. In being silent on the tax treatment of LLCs, we believe that the New York characterization of LLCs would be in full conformity with the federal income tax classification of LLCs. Thus, in most cases, the LLC would be treated as a partnership. Clearly, full conformity with the treatment of LLCs for income tax purposes presents none of the problems of complexity, burdensome technical analysis and sophisticated tax planning that are raised by the DTF Bill and the Ways & Means proposal. By avoiding the creation of a peculiar LLC tax regime, this Bill is well designed to encourage broad use of the LLC vehicle in New York.

In addition, the Bill imposes various fees on LLCs for such things as filing the articles of organization ($200); filing articles of amendment ($60); and filing certificates of termination, merger or consolidation ($60). The fees imposed under the Bill appear to us to be reasonable in amount, readily understood and easy to apply and to collect. As discussed in greater detail below, we believe that a fee approach is the best mechanism to raise revenues without undermining the utility of the LLC in New York.

We are not familiar with the relationship of the Bill to the revenue parameters articulated by the Executive branch in its discussions with the Tax Section's LLC Task Force.

E. Possible Fee Approach.

In terms of simplicity, the imposition of fees on LLCs or their members could well be the best way to fill the projected LLC revenue gap within the “revenue neutrality” parameters adopted by the Department. The Department has prepared and reviewed with its LLC working group two forms of fixed fees -- an assets-based fee and a receipts-based fee. For various policy reasons neither of these fee approaches was considered acceptable by the Department, but we think these proposals should be given wider exposure and further consideration.

In addition, there are other types of fee approaches to consider. For example, the state of Texas imposes a $100 per member fee for qualification as a Texas L.L.P. A similar, or even higher, member-based fee could raise substantial amounts of revenue without operating as a broad disincentive to the use of LLCs in New York. Other states, such as California, impose fees on pass-through entities, and this also bears consideration.

Consideration also should be given to capturing the funds currently expended in satisfying New York's publication requirements. While these monies are realized only once, upon the formation of the LLC, nevertheless these amounts could represent a substantial source of revenue for New York.

We recognize that a fee approach has deficiencies. Fixed fees are perceived to be regressive. However, when one takes into account the fact that members of LLCs will pay income and franchise taxes on the full amount of LLC income at the member level, the regressivity of an LLC fee is no greater than many other kinds of fees and charges imposed by the State for various privileges (for example, minimum corporate franchise taxes). Questions also have been raised about tailoring fixed fees to grow with the economy.

Notwithstanding these questions, the fee approach presents some real advantages. The imposition of fees could provide an immediate infusion of revenue to the State; instead of having to wait for new LLCs to mature into net income taxpayers, the State could begin collecting fees immediately. Furthermore, fees can be fairly simple, and again we emphasize the importance of eliminating complexities and uncertainties. Finally, fee-based taxation is arguably less subject to decline in adverse economic circumstances than income-based taxes, thus assisting in revenue forecasting. The utility of the LLC vehicle in New York would, in our view, be much greater under a system of simple and reasonable fees than under either of the fairly sophisticated income tax approaches developed to date.

F. Tax Clearance Certificate Problems.

In connection with various proposals to impose entity-level taxes on LLCs it has been suggested that the statute should provide that a certificate of merger will not be filed by the Department of State unless the consent of the Commissioner of Taxation and Finance to the merger or consolidation is attached to the certificate of merger. We believe that this provision is unnecessary and may serve to discourage the use of New York limited liability companies. The proposed LLC legislation provides that all of the debts, obligations, liabilities, penalties and duties of a New York limited liability company will be vested in the surviving or resulting limited liability company, and that all rights of creditors and all liens upon property are preserved unimpaired and shall attach to the surviving or resulting limited liability company and may be enforced against it to the same extent as if such debts, obligations, liabilities, penalties and duties had been incurred or contracted by it.

The tax clearance procedure in New York is cumbersome and time-consuming, in some cases taking more than one month, even when no taxes are due. To impose the requirements of a tax clearance certificate could lead businesses to use an out-of-state limited liability company, instead of a New York limited liability company, in order to side-step the New York tax clearance procedure and facilitate future mergers and other business transactions. We believe that New York should rely on the surviving entity of any merger to assume the liabilities and obligations of the entity being merged or consolidated, and does not need to impose the tax clearance requirement.

We appreciate the opportunity to offer our comments, and we will be available to comment further as the LLC tax legislation continues to develop.

Very truly yours,

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