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# LLC, LLP, PC, LP Business Formation Rules





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## What are some other business entities and how are they taxed at formation?

In addition to C corporations, S corporations, partnerships, and sole proprietorships, four other business entities are particularly common: limited liability companies (LLCs), limited liability partnerships (LLPs), limited partnerships (LPs), and professional corporations (PCs). When forming one of these entities, it is important for you to know the tax consequences of transferring cash or property to the business in exchange for an interest in the business, as well as what impact the exchange will have on tax basis.

## What is a limited liability company (LLC)?

A limited liability company (LLC) is a business entity created and regulated under state law. LLC laws allow companies that operate as partnerships to benefit from the limited liability characteristics of corporations. This means that LLCs give their owners, who are called "members," protection from the claims of business creditors. The liability of an LLC member for business debts is limited to the value of his or her individual ownership interest in the LLC. Unlike partners in a limited partnership, all LLC members can take an active role in the operation of the business without exposing themselves to personal liability.

An LLC is created by filing the articles of organization (a document that outlines the company's purpose and structure, and provides contact information) with the secretary of state's office in its home state. The name of the business entity must include a designation that it is a limited liability company, meaning that LLC or LC must appear in the name. In addition, you must create an operating agreement in which you describe, among other things, how the LLC is to operate and the relationship between members.

### ***Tax reporting***

Note that although most states tax LLCs according to partnership tax rules, some states tax LLCs as corporations (even though LLCs qualify to be taxed as partnerships for federal tax purposes). For federal tax purposes, the LLC can choose to be treated as a partnership or as a corporation. There is little or no reason for it to choose to be treated as a corporation, however. If treated as a partnership, the LLC must issue each member an IRS Schedule K-1 at the end of each year, showing his or her proportionate share of the business's profit or loss. Because most LLCs, like partnerships and S corporations, do not pay federal income taxes, their income is taxed at a single level to the members. If an LLC has only a single individual owner, the LLC will be treated as a sole proprietorship for federal income tax purposes, unless it elects to be treated as a corporation. However, you should be aware that some states do not permit or recognize LLCs owned by a single person.

### ***If you establish an LLC and transfer property to it in exchange for an LLC interest, what are the tax consequences?***

An LLC is capitalized with contributions made by its members through cash, property, services rendered, and promissory notes. As a general rule, no gain or loss is recognized by either the LLC or the member when property including cash is contributed in exchange for an interest in the LLC. Be aware, however, that if you receive an LLC membership interest as a payment for services, you may be subject to taxable ordinary income. Converting an existing business into an LLC may involve some tax issues. For more information, contact an accountant or attorney.

### ***If you exchange property for an LLC interest, what will be your tax basis?***

A member's basis in his or her ownership interest in an LLC is determined in the same manner as for an ownership interest in a general partnership. If each contributes only cash for his or her LLC interest, then each member will have a tax basis equal to the amount of cash he or she contributed. Over time, a member's basis will increase or decrease frequently.

### ***What basis will the LLC take in the property received?***

An LLC's basis in contributed property generally is the same as the contributing member's tax basis in the property.



## What is a limited liability partnership (LLP)?

Most states allow professionals (such as doctors, lawyers, and accountants) to form an entity similar to the LLC. This entity is called a limited liability partnership (LLP). An LLP is a partnership organized under state statutes that give a degree of liability protection to individual partners. Partners in a general partnership are liable for all partnership obligations, including the negligence or malpractice of other partners. Once an LLP business is properly registered, however, the partners of the LLP generally do not have liability for the malpractice of the other partners but still remain liable for their own acts.

The designations LLP or public LP must become part of the firm name and be used in all legal transactions and advertising.

### ***Tax reporting***

For federal tax purposes, an LLP follows the same entity classification rules as an LLC. That is, it can elect to be taxed as a corporation or as a partnership. In general, partnership taxation is more advantageous, however, so most LLPs will choose to be taxed as partnerships.

### ***If you establish an LLP and transfer property to it in exchange for an LLP interest, what are the tax consequences?***

An LLP is capitalized with contributions made by its partners through cash, property, services rendered, and promissory notes. As a general rule, no gain or loss is recognized by either the LLP or the partner when property including cash is contributed in exchange for an interest in the LLP. Be aware, however, that if you receive an LLP interest as payment for services, you will be subject to taxable ordinary income. Converting an existing business into an LLP may involve some tax issues. For more information, contact an accountant or attorney.

### ***If you exchange property for an LLP interest, what will be your tax basis?***

A partner's basis in its interest in an LLP is determined in the same manner as for an ownership interest in a general partnership. If each partner contributes only cash for his or her LLP interest, then each will have a tax basis equal to the amount of cash he or she contributed. Over time, a partner's basis will increase or decrease frequently.

### ***What basis will the LLP take in the property received?***

An LLP's basis in contributed property generally is the same as the contributing partner's tax basis in the property.

## What is a limited partnership (LP)?

A limited partnership (LP) is defined as a partnership with one or more general partners and one or more limited partners. General partners are liable for all partnership debts and obligations, whereas limited partners are liable only for the value of their individual ownership interest (their capital contribution) in the partnership.

Although LPs are similar to LLCs and LLPs, there are a number of differences, as well. For instance, although most states forbid limited partners from participating in management decisions, LLC members are free to participate in management.

### ***Tax reporting, exchange of property, and tax basis***

Limited partnerships generally follow the same tax rules as general partnerships.

## What is a professional corporation (PC)?

Professional corporations (PCs), or qualified personal service corporations (as they are sometimes called), are a special type of corporation composed of professionals. Under the tax code, a qualified personal service corporation is defined as a corporation formed under state law in which substantially all of the activities involve services in the fields of health, law, engineering, accounting, actuarial science, performing arts, or consulting.

Most state laws forbid professionals from forming regular corporations. However, the urge to incorporate reflects a desire to take advantage of Internal Revenue Code provisions that grant more generous deductions or other tax allowances for corporate employee benefit plans than for similar plans created by self-employed individuals. The owners of PCs are its shareholders, who



perform services for the corporation as employees. The IRS imposes two tests to ensure that a corporation under state law qualifies as a personal service corporation. These tests focus on what the corporation does (the "function test") and how it is owned (the "ownership test"). If a PC does not qualify as a personal service corporation, then it is generally treated under the tax code as a C corporation. Bear in mind, however, that a PC can elect to be treated for tax purposes as an S corporation.

## ***Tax reporting***

The tax treatment will depend largely on how much of the outstanding stock is owned by employee-shareholders. In general, though, a PC is a separate entity from its owners, similar to a C corporation. Therefore, it must file its own corporate tax return every year, and it may offer many of the fringe benefits available to C corporations. As noted, however, a PC can elect to be treated as an S corporation.

Qualified personal service corporations are not taxed at the same graduated rates that apply to C corporations. Rather, PCs are taxed at a flat 35 percent rate on their taxable incomes. PCs are subject to the passive activity loss rules and the at-risk rules. For more information, contact an accountant or attorney.

## ***If you establish a PC and transfer property to it in exchange for stock, what are the tax consequences?***

Like a C corporation, a PC does not recognize gain or loss when it issues stock. As for the shareholders, they generally do not incur immediate tax consequences when buying stock to capitalize the business, because gain or loss will be determined later when the stock is sold or otherwise disposed of. Section 351 of the Internal Revenue Code applies to the incorporation of a PC, just as it applies to a C corporation. As with a C corporation, be aware of the concept of "boot."

## ***If you exchange property for PC stock, what will be your tax basis?***

In the simplest situation (i.e., an exchange under Section 351 of property solely for stock), your basis in the stock will be the same as your basis in the property transferred. This is referred to as a substituted basis. If, however, the exchange did not satisfy the requirements of Section 351 (i.e., you immediately recognized gain or loss), the basis of the stock would be its cost (i.e., the fair market value of the property given up) rather than your basis in the property.

Furthermore, if you receive cash or "boot" in addition to the stock, the calculation becomes a bit more complicated.

## ***What basis will the PC take in the property received?***

PCs generally follow the same tax rules as C corporations. Thus, in a Section 351 transaction, the PC takes a substituted basis in the assets received in return for stock.



**IMPORTANT DISCLOSURES** This presentation is not intended to and does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.



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