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Business Law

The Joy of Being Disregarded

By Lin Hanson

Many of your Mom-and-Pop business clients will prefer the simplicity and cost savings of being a "disregarded entity" for tax purposes, which lets them file using Schedule C of their 1040 rather than a separate form for the business. How do you help them do it? Read on.

Drafters of Illinois's limited liability company law sought to create a flexible and relatively informal system with low administrative costs. Nearly 20 years after Illinois adopted its first LLC act, it seems they met those objectives to the benefit of the business community.

An LLC is an entity created by state statute. The IRS uses tax-entity classification, which allows an LLC to be taxed as a corporation, partnership, or sole proprietor, depending on elections made by the LLC and the number of members. An LLC is always classified under federal law as one of these types of taxable entities.

Becoming a "disregarded entity"

A single-member LLC (SMLLC) can be either a corporation or a "disregarded entity," which is taxed as a sole proprietor on Schedule C of the owner's personal Form 1040. To be treated under federal law as a corporation, the SMLLC has to file Form 8832 and elect the "corporation" classification. An SMLLC that does not elect to be a corporation will be classified as a disregarded entity.

For the Mom-and-Pop business, simplicity and cost saving are typically important. By choosing an LLC over a corporation as their entity they eliminate the need for annual meetings, minutes recording action at those meetings, and the attendant legal fees. The cost saving (or time saving for do-it-yourself clients) is significant. If their business can also achieve disregarded-entity status, they won't need to have state and federal income tax returns prepared for the company. The saving in accounting fees or time is significant.

Does a company owned by a husband and wife constitute a SMLLC? The answer is not necessarily intuitive. The Internal Revenue Service has ruled (Rev. Proc. 2002-69) that the entity is disregarded if (1) it is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States; (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) it is not treated as a corporation under section 301.7701-2.

Thus, if the husband and wife are residents of a community property state like Wisconsin or California, the LLC can be considered a SMLLC and disregarded. No similar ruling has been made with regard to residents of common law states like Illinois. The Internal Revenue Service has given every indication, however, that a husband and wife residing in a common law state and owning 100 percent of an LLC will not automatically produce a disregarded entity.

Thus, common law state residents will be forced to file a partnership return for such an LLC. If a federal partnership return is filed, the state of Illinois requires one as well.

The Uniform TOD Security Registration Act

So what do you advise your husband and wife Illinois resident clients who seek the benefit of the disregarded-entity rule? You tell them to move to Wisconsin, but then they would have to endure those cold north-of-the-border winters.

There may be another way. The Uniform TOD Security Registration Act (815 ILCS 10/0.01 et seq.) permits an owner to register real or personal property, or any interest therein, in beneficiary form. "Property" is defined in the Act as "both real and personal property or any interest therein" and means anything that may be the subject of "ownership." "Beneficiary form" is defined as "a registration of a security which indicates the present owner of the security and the intention of the owner regarding the person who will become the owner of the security upon the death of the owner."

"Security" is defined as "a share, participation, or other interest in property, in a business, or in an obligation of an enterprise or other issuer, and includes a certificated security, an uncertificated security, and a security account." Hence, either spouse could be the sole owner of the entire membership interest in an LLC, registering it in beneficiary form to transfer on the death of that spouse to the other spouse. The form of registration is set out in the act as follows: "Registration in beneficiary form may be shown by the words 'transfer on death' or the abbreviation 'TOD', or by the words 'pay on death' or the abbreviation 'POD', after the name of the registered owner and before the name of a beneficiary."

Additionally, the spouses could, either by separate written agreement or in a provision in the LLC's operating agreement, explain what they are doing and why and require the owner spouse to transfer half of his or her membership interest to the other spouse if 1) the LLC ever ceases to be a disregarded entity or 2) their marriage ends.

If the provisions are included in the operating agreement, the non-member spouse should be specifically identified as a third-party beneficiary of the provision(s) regarding the disregarded status and membership. Consideration for the agreement could be the non-member spouse's waiver of the right to be a member to qualify the company as a disregarded entity.

The language of the operating agreement might be as follows:

DISREGARDED ENTITY

a. Member's Marital Status. [Mary Smith] is married to [Harry Smith]. They reside in Illinois, which is not a community property state. They desire to own [Company Name LLC] in joint tenancy, but they also desire that [Company Name LLC] be treated for tax purposes as a disregarded entity.

b. Single Member. [Harry Smith] has agreed with [Mary Smith] that [Mary Smith] shall be the sole (single) member of [Company Name LLC] in order that [Company Name LLC] may obtain disregarded entity status for tax purposes. [Mary Smith] has agreed that the membership shall be registered "TOD [Harry Smith]" in order that [Harry Smith] may have assurance that the membership shall belong solely to [Harry Smith] in the event of [Mary Smith]'s death.

c. Loss of Disregarded Status. In the event [Company Name LLC] shall ever cease to be a disregarded entity, or in the event that [Mary Smith] and [Harry Smith] shall no longer be husband and wife, [Mary Smith] agrees to transfer a 50% membership interest to [Harry Smith] without any further consideration.

d. Third Party Beneficiary. [Mary Smith] and [Company Name LLC] agree that [Harry Smith] is an intended third party beneficiary of this Article and of this Agreement.

e. Spouse's Signature. The non-member spouse's signature is attached to this Agreement, to indicate an assent to be bound by all the terms and conditions of this Agreement so that if any portion of the membership interest is ever transferred to the non-member spouse by virtue of the terms of this article or otherwise, such spouse shall become a member immediately and automatically, without further action of any person.

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