

LLC Operating Agreement Tax Trap; IRS Ruling

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In November 2022, the IRS issued a Private Letter Ruling which confirmed that Subchapter S status was terminated because the LLC operating agreement contained Section 704 partnership tax provisions governing distributions and capital account maintenance. These provisions in the operating agreement provided for disproportionate distributions which resulted in a termination of Sub S status; even if disproportionate distributions were never made.

In a previous [tax alert](#), we noted that business owners should discuss entity selection with their CPA and attorney and select the best of potentially three available tax elections for an LLC. Unlike a corporation's shareholder's agreement, an LLC operating agreement must be carefully drafted to include appropriate provisions matching the tax status elected by the LLC. There are multiple tax differences between an LLC being taxed as a partnership and an LLC taxed as an S Corporation.

Termination of Sub S status can result in double taxation and the assessment of additional self-employment and other taxes. The tax provisions of an operating agreement should be carefully considered at the time of formation of the LLC and also later when a change in tax classification status is being considered.

If you have any questions about the latest Private Letter Ruling, please contact [David Rattigan](#), [Charmaine Nyman](#), [Alexandra Otto](#) or anyone in the [Business Practice Group](#).

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