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Bill Harden

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The Adviser's Guide to S Corps, C Corps, Partnerships, LLCs, and Sole Proprietorships: Making the Right Choice

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Bill Harden, CPA, ChFC, Ph.D.

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Bill Harden, CPA, ChFC, Ph.D.

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Preface

Entity Choice

Introduction

The question of which entity form a business should adopt has become more complex. Decades ago, businesses desiring better retirement plans for their owner-employees were forced into the corporate form. Likewise, those preferring a single level of tax remained in a traditional proprietorship or partnership form depending on the number of owners involved. Since then, the rules affecting retirement plans for noncorporate entities have expanded to provide enough parity that this no longer dominates the choice of entity. The rules for S corporations became much friendlier in the early 1980's, increasing their popularity and expanding the possibilities for those businesses that desired flow-through tax treatment with the traditional corporate liability protection. In more recent years, the addition of the limited liability company (LLC) and the limited liability partnership (LLP) have allowed for even more options.

A life cycle of an entity involves its birth, its life, and its death. In the context of a business entity, these terms would translate into the formation, the operations, and the liquidation, or perhaps reorganization, of the entity. The narrative of this book will follow this life cycle approach. It will begin with an overview to the available choices, including a discussion of why a separate entity would be desirable. It will then review the effects of formation, operation, liquidation, reorganization of, and estate planning for the entity.

It is the author's opinion that the best starting point for determining the entity of choice is determining the owner's ultimate goal for the business. Since you cannot take it with you, the question becomes how will the owner ultimately dispose of the business? If it is to be passed through an estate to the owner's heirs, a vehicle taxed as a partnership may provide some unique advantages. On the other hand, if the owner plans to sell the business, and a stock sale rather than an asset sale could be accomplished, one of the corporate forms may have an advantage.

Next, what is the desired treatment while the business is operating? Does the owner desire a single level of tax, or is the income picture of the owner such that there is a desire to shield a small amount of income at the lowest corporate rate? If a flow-through is selected, there are significant self-employment tax implications based on which entity form is selected. Is there a desire to be able to allocate distributions disproportionately to the ownership interests in the business? These questions all have implications for which entity is best.

At formation, what types of property are going to be contributed? Will additional properties be contributed in later transactions? Are services going to be provided in exchange for some ownership interests? These questions also have implications. All of these questions will be addressed.

Rather than select a single particular fact pattern and analyze this single fact pattern, this book contains various fact pattern scenarios at the end of each chapter. Through the use of these

scenarios, readers are able to see that in some cases one form of entity would be preferable, while under alternative facts a different entity would be chosen.

In addition, it may be that in many cases multiple entities may be used to achieve the goals of the client, rather than a single entity. For example, picture a manufacturing activity in which the owner of the operating business also owns the real property used by the business and also owns an intangible right related to the production process. In this case, the CPA might recommend that the operating business itself be run as an S corporation, with the real property and the intangibles held in separate LLCs which then lease the properties to the S corporation.

Why this strategy? An S might be preferred for the ordinary operations to allow a single level of taxation, and so that the share of ordinary income that accrues to the owner above the amount of reasonable salary is not subjected to self-employment tax. Placing the property into LLCs allows for the separate sale of these assets, should that ever be desired. Also, these are the types of property that may appreciate in value while held by the entity, and which the owner might desire to retain even if the operating business were sold. Should the owner desire to remove these properties from an entity form, a vehicle taxed as a partnership is less likely to create tax issues, than would the corporate form. Moreover, if one owner of the operating activity owns all of the property, but not all of the operating entity, it may be preferable to keep these assets separate and wholly-owned rather than contributing them to the operating entity in case the joint operation of the entity is someday terminated.

The separation of properties in this manner may also provide a greater overall liability shield than keeping all the properties in the same entity. The liability issue is one that should be considered with the advice of an attorney. For some types of business, the liability concerns are much greater than the tax costs of a particular entity. An attorney experienced in corporate and LLC liability law can shed light on this part of the decision process. The case law in the LLC area is less settled, compared to that of corporations. While many beginning businesses will have the owner and the business in the same geographic location, this may not always be the case. While this book focuses on federal tax issues, state and local issues can play a large part in deciding which entity is best in the long run for a particular business.

For those businesses in which the owner and the business operation will be conducted in an area along a state border, the choice of which state both to live in and to operate the business in must be considered concurrently with the choice of entity. Some states have much more favorable tax treatment for certain types of entities. For example, states in which there is no individual income tax tend not to recognize flow-through entities such as S corporations or LLCs as flow-through entities, but instead tax them in the same manner as corporations. Even in cases in which the possible states do honor flow-through treatment, tax-rate differences alone may be considerable.

One such scenario to note would be a business and individual owners that could operate equally well out of either of two states, one of which has no individual or corporate income tax while the other has both and imposes some of the highest tax rates in the nation. Also assume that the business could obtain exactly equal legal protections and outcomes in either state. While the sales into the state with the income tax (and any other state in which the corporation had nexus) would be subject to apportionment there, the state income tax liability related to income for which no other state could claim an inclusion would face no income taxation for the business and owner located in the no-tax state. Of course, this also assumes that equal infrastructure and

quality of life exist in both states. If the no-tax state is, for example, landlocked desert, while the owner prefers to live near open water or the business needs a port for shipping, the tax costs may not be as important as these non-tax costs. It is also possible that other taxes such as sales and property taxes in the state with no income taxes will be higher than those of the income tax state by a large enough amount to offset the state income tax burden.

Another occasion in which multiple entities may be desirable is the case of an owner with multiple rental properties. Separating the properties into separate entities may limit the damages, should the owner be sued, to the property in that single entity rather than to the aggregate of all the rental properties. Assuming this liability protection would hold, the issue becomes one of whether the increased costs of operating separate entities, rather than a single holding company, are offset by the liability protection. For federal purposes, the ability to structure through disregarded and flow-through entities will make the costs of using multiple entities minimal. The states, however, may again have annual filing requirements and costs that are more than the value of the liability protection. In other words, the client should consider what would be the cost of insuring for the risks that are of concern (assuming such insurance is available), and whether insurance would be less expensive than the cost of operating the multiple entities.

As the reader moves through the materials, it will be clear that a one-size-fits-all solution to the question of which entity is best, cannot be provided. However, the reader will gain insight into the federal tax issues that affect the choice of entity. This will allow for a more informed discussion with, and recommendations to, clients about the choice of entity.

While no absolute statement can be made about which entity is best in every circumstance, a few general rules can help in the decision process:

- An entity taxed as a flow-through is generally preferable to a double-taxed entity, although with the lower rate of tax on dividends currently in effect it is mathematically possible in some cases of low corporate and high individual income for the reverse to be true. However, care should be taken because unraveling the C corporation may be costly. If a C form is selected, the client should probably anticipate having to move to the S corporation form rather than the partnership form, should a move to single taxation become desirable.

- Flexibility of both subsequent changes of form and changes in allocations and distributions will favor a partnership-taxed form.

- Self-employment tax issues (assuming a reasonable salary is paid) will favor the S corporation form.

- A desire to have strict structure will favor one of the corporate forms.

- The need to use debt basis through entity borrowing to support the flow-through of losses requires a form taxed as a partnership. If the owner is borrowing outside the entity and loaning to the entity, then either the partnership or S corporation form of taxation can be used.

- Foreign ownership will eliminate the S corporation as a possibility, as will other ownership restrictions incorporated into the S corporation rules.

- Estate planning will typically prefer the LLC/partnership form over the corporate forms. This is because of the ability to make a §754 election and disproportionate distributions during the owner's life.
- Stock sale treatment is generally preferable to the sale of a partnership interest if there are ordinary income assets inside the partnership because of §751. However, many corporate buyers will require an asset sale or a stock sale taxed as an asset sale in order to achieve a step-up in basis. If this is done, then the corporate sale treatment advantage disappears.

The next six chapters will provide guidance in the areas described above in order to assist CPAs in assessing the implications of the entity-choice decision throughout the life cycle of the business. While it is impossible to know in advance all of the contingent outcomes that could impact the business, it is important to discuss with the client the tax issues related to formation, operation, distribution(s), and business succession in order for you to help them to make the best decision.

Contents

Chapter 1: General Considerations
Types of Entities ... 1-1
A Regular Corporation (Also Known as a C Corporation) ... 1-1
An S Corporation ... 1-2
Professional Service Corporation ... 1-2
General Partnership ... 1-3
Limited Partnership ... 1-4
Limited Liability Company (LLC) ... 1-4
Limited Liability Partnerships (LLPs) ... 1-5
Disregarded Entities ... 1-5
Use of an Entity ... 1-6
Case Studies ... 1-7
Case Study 1-1: Creditor-Protection Strategies ... 1-7
Facts ... 1-7
Discussion ... 1-8
Case Study 1-2: Protecting UTMA Assets from a Minor Child ... 1-8
Facts ... 1-9
Discussion ... 1-9
Case Study 1-3: Changing the Situs of Real Property ... 1-10
Facts ... 1-11
Discussion ... 1-11
Case Study 1-4: Minimizing Risk of Dealer Status ... 1-11
Facts ... 1-11
Discussion ... 1-11
Case Study 1-5: Selling a Principal Residence to a Controlled Entity ... 1-14
Facts ... 1-14
Discussion ... 1-14
Case Study 1-6: Valuation Discounts Using Partnerships ... 1-15
Facts ... 1-15
Discussion ... 1-15

Chapter 2: Entity Formation
Overview ... 2-1
How Difficult Is It to Form an Entity? ... 2-1
Tax Consequences of Formation ... 2-2
General Discussion ... 2-2
Transfers to a Corporation ... 2-3
Transfers to a Partnership ... 2-5
S Elections ... 2-7
Case Study 2-1: The One-Member Entity ... 2-8
Facts ... 2-8
Discussion ... 2-8
Case Study 2-2: Control Issues with Transfers to Corporations ... 2-9

Facts 2-9
Discussion 2-9
Case Study 2-3: Control Problems for Later Transfers 2-13
Facts 2-13
Discussion 2-13
Case Study 2-4: Contributing Property with Liabilities in Excess of Basis 2-14
Facts 2-14
Discussion 2-14
Case Study 2-5: Liability Transfers with Tax Avoidance 2-16
Facts 2-16
Discussion 2-16
Case Study 2-6: When Money Has Been Borrowed Shortly Before Transfer to an Entity 2-18
Facts 2-18
Discussion 2-19

Chapter 3: Operations

Salary and Self-Employment Tax Issues 3-1
Losses and Use of Debt Basis 3-4
Partner's Basis 3-4
S Shareholder's Basis 3-5
At-Risk Rules 3-6
Passive Loss Rules 3-7
Allocations in Flow-Through Entities 3-8
Overview 3-8
S Corporation Allocations 3-10
Partnership and LLC Allocations 3-12
Retirement Plans 3-23
Fringe Benefits 3-24
Case Study 3-1: Income and Cash Flow Priority 3-24
Facts 3-24
Discussion 3-25
Case Study 3-2: Using Special Allocations 3-26
Facts 3-26
Discussion 3-27
Case Study 3-3: Allocations with Respect to Precontribution Gain or Loss 3-28
Facts 3-28
Discussion 3-29
Case Study 3-4: Payroll Tax Comparison 3-33
Facts 3-33
Discussion 3-33
Case Study 3-5: Rewarding Service Providers for Future Profits of the Entity 3-34
Facts 3-34
Discussion 3-34

Chapter 4: Distributions

Overview 4-1
C Corporation Distributions 4-2
Double Taxation 4-2
Dividends 4-2
Avoiding Two Levels of Tax 4-3
Other C Corporation Issues 4-4
Distributions by S Corporations 4-5
Overview 4-5
Distributions When the S Corporation Has Earnings and Profits 4-6
Distributions from an S Corporation Without Earnings and Profits 4-7
The Tax Effects of Distributions on the Corporation 4-8
Partnership Distributions 4-9
Overview 4-9
Disproportionate Distributions of Section 751 Assets 4-10
Disguised Sale Provisions 4-11
Early Trigger of Section 704(c) Gain 4-12
Marketable Securities as Cash 4-15
Case Study 4-1: Avoiding Two Levels of Tax for Distributions 4-16
Facts 4-16
Discussion 4-16
Case Study 4-2: Avoiding Gain Recognition from Property Distributions 4-17
Facts 4-17
Discussion 4-17
Case Study 4-3: Disproportionate Distribution-Partnership Complexity 4-18
Facts 4-18
Discussion 4-18
Case Study 4-4: Distributions of Marketable Securities 4-20
Facts 4-20
Discussion 4-20

Chapter 5: Sales and Reorganizations

Overview 5-1
Sales of Business Interests 5-1
Sale of Stock or Assets 5-1
Sale of Partnership Interest 5-3
Using Corporations in Nontaxable Acquisitions 5-4
Operating Rules of Corporate Reorganizations 5-5
Treatment of Target Shareholders (§§354, 356, and 358) 5-6
Treatment of Target Corporation §§357, 361, and 381 5-7
Treatment of Acquiring Corporation—§§362, 381, and 1032 5-8
Judicial Doctrines Applicable to Reorganizations 5-8
Nontaxable Divisions of a Corporation 5-15
Mergers and Divisions of Partnerships 5-15
Conversion of a Corporation to a Partnership 5-16
Overview 5-16

Liquidation of Corporation, Followed by Contribution of Assets (Alternative 1) 5-17
Transfer of Stock Followed by Liquidation of Corporation (Alternative 2) 5-18
Asset Transfer by the Corporation, Followed by Distribution of the Interest (Alternative 3) 5-19
Asset Transfer Followed by Continuation of Corporation (Alternative 4) 5-20
Restructurings Involving Disregarded Entities 5-21
Case Study 5-1: Acquisition of Business Assets 5-23
Facts 5-23
Discussion 5-23
Case Study 5-2: Acquisition of Interests in a Business 5-25
Facts 5-25
Discussion 5-26
Case Study 5-3: Division of a Business 5-28
Facts 5-28
Discussion 5-28
Case Study 5-4: Conversion of a Corporation to an LLC 5-29
Facts 5-29
Discussion 5-30
Case Study 5-5: Acquisition of Corporate Stock and Section 338 5-31
Facts 5-31
Discussion 5-31

Chapter 6: Estate Planning Issues
Overview 6-1
The Unified Transfer Tax System 6-1
Unified Tax Base and Tax Rates 6-1
Special Rules for 2010 6-2
Annual Exclusion for Gift Transfers 6-3
Lifetime Gifts of Property 6-3
Basic Advantage 6-3
Giving Stock in a Closely Held Business 6-3
Gifts to Minors or in Trust 6-4
Qualifying Transfers in Trust for the Annual Gift Exclusion 6-4
Charitable Remainder Trusts and Business Interests 6-5
Description 6-5
Advantages of Charitable Remainder Trusts 6-6
Succession Planning in a Closely Held Business 6-7
Overview 6-7
Buy-Sell Agreements 6-8
Reducing the Estate Valuation of the Business Interests 6-9
Lack of Marketability 6-9
Minority Discount and Control Premium 6-9
Family S Corporation Issues 6-9
Family Partnership (or LLC) Issues 6-11
Family Partnerships and §704(e) 6-12

Section 754 Basis Adjustments ... 6-13
Corporate Redemptions to Pay Death Taxes ... 6-13
Why a Recapitalization? ... 6-14
Case Study 6-1: Charitable Remainder Trust ... 6-14
Facts ... 6-14
Discussion ... 6-15
Case Study 6-2: Basis Adjustments after Death ... 6-17
Facts ... 6-17
Discussion ... 6-17
Case Study 6-3: Using Family Limited Partnerships and LLCs for Valuation Discounts ... 6-18
Facts ... 6-18
Discussion ... 6-18
Case Study 6-4: Corporate Stock Redemption from an Estate ... 6-19
Facts ... 6-19
Discussion ... 6-20

Chapter 1
General Considerations

Types of Entities

For financial accounting purposes, businesses are treated as separate from their owners. For tax purposes, however, a business form such as a sole proprietorship is treated as a part of the underlying owner and is not respected as separate from the owner. Likewise, for liability-protection purposes, entities that are not created under state law to provide liability protection may expose the owner of the business to risk of loss with respect to nonbusiness assets as well as those of the business.

Following are the most common entities that can be formed in most states. Depending on the form selected, the entity may be respected as separate from the owner for both tax and nontax purposes. Many of the issues described briefly below will be covered in more detail throughout the book.

A Regular Corporation (Also Known as a C Corporation)

A corporation is an entity formed under local law. Domestically within the US, this will be an entity that is properly formed under the laws of a given state. For purposes of the tax discussions in this book, it may also include an unincorporated entity that is classified as an association under §7701(a)(3).

Corporations must be formed to comply with state law requirements. Such requirements are generally quite easy to satisfy, but a corporation cannot be informally created as can a general partnership. Corporations generally protect shareholders from liabilities of the corporation, although closely held corporations like other closely held businesses are unlikely to be able to borrow without the personal guarantee of one or more shareholders. Corporations will also survive the death of one or more owners, and ownership interests are freely transferable unless restricted by agreement.

The traditional advantages of the corporate form for small businesses are limited liability and the ability to treat the entity as separate from the owner for tax purposes. Note, however, that there are related-party provisions to prevent abuse, typically for those owning more than 50 percent of the corporation. The ability to treat owners who work within the business as employees for fringe benefit, most notably retirement, purposes was critically important at one time, but this consideration has been greatly reduced in recent decades through the expansion of retirement plan benefits to other entity forms.

The primary tax disadvantage of the standard corporate form is the imposition of a double layer of taxation. A corporation is taxed as a separate entity and distributions of earnings in the

corporation to owners are taxed as dividends.[1] This double taxation is not limited to cash distributions, but also applies to distributions of appreciated property if earnings and profits are present in the corporation. Dividends paid by corporations to corporate shareholders are eligible for a dividends-received deduction based on the level of stock ownership.

An S Corporation

An S corporation is an entity formed as a corporation under local law that has a valid election under subchapter S. An S corporation must meet eligibility requirements as specified in §1361(b) and must have an election that complies with the requirements of §1362. Unincorporated entities that are treated as associations under §7701(a)(3) are eligible to make an S election provided the eligibility requirements of §1361(b) are otherwise satisfied.

The S corporation form allows for a single level of taxation at the shareholder level. The requirements for maintaining S status are restrictive. While there is a limit of 100 shareholders, this is actually not an issue for most S corporations as they typically have only a handful of shareholders. For a corporation with more than 100 shareholders, an S election would not be an option. For most closely held businesses, the factors that tend to make S status difficult are the requirements that distributions be based on stock ownership (with only a single class of stock), and the limits on which types of taxpayers can be S shareholders. For example, an entity with a foreign individual desiring to be an owner would not be eligible for S status.

Through the check-the-box regulations, an unincorporated entity, such as an LLC whose owners meet the requirements, could elect to be taxed as a corporation and elect S status. If this is done, care should be taken to make sure that the operating agreement of the entity does not operate in a manner that would create a second class of stock. For an entity in this situation, an attorney familiar with this issue should make sure that the operating agreement will not be problematic.

The S corporation has seen increased popularity in recent years relative to LLCs taxed as partnerships due to the ability to pay a salary to owners who work in the business to limit the self-employment tax exposure on corporate earnings not paid out as salary. However, it is important that a reasonable salary be paid to shareholder employees.

It should also be noted that not all states honor the S election (typically those that do not impose an individual income tax). Therefore, an S election may provide only one level of tax for federal purposes but still subject the entity to an entity-level tax at the corporate level for state purposes.

Professional Service Corporation

A professional service corporation (PC) is formed under state law. Before PC statutes appeared beginning in the 1960s, professionals were not permitted to incorporate because public policy considerations suggested that professionals not be able to limit their liability for acts of professional misconduct. Professionals sought the corporate form because the retirement benefits

[1] Current law (through 2012) provides individual owners with a preferential rate on qualified dividends equal to the long-term capital gains rate of 15 percent (zero percent).

available for corporate employees were superior to those available to partners or sole proprietors.[2]

Professional corporations do not generally offer any liability shield for acts of professional misconduct, although the owners may be able to limit their liability to their own acts and the actions of those directly under their control, avoiding the vicarious liability of a general partnership. PCs may elect to be S corporations if they otherwise qualify, and many owners choose this alternative to avoid tax at the corporate level.

General Partnership

A general partnership is a partnership in which all of the partners are general partners. General partners are jointly and severally liable for debts of the partnership. Thus, a general partnership does not shield its owners from liabilities of the entity. Although it is best to have a formal partnership agreement, a general partnership may be created quite informally and need not have a written agreement. The Uniform Partnership Act defines a partnership as "an association of two or more persons to carry on as co-owners of a business for profit," with a business defined to include "every trade, occupation, or profession." Thus, the partners need not refer to the entity as a partnership if they satisfy the requisite motive of carrying on and dividing the profits from a business.[3]

A partner in a general partnership therefore accepts a great deal of risk. This can be reduced if the owner of the partnership interest is itself an entity that provides limited liability to its owners. While the partnership may be operated without an agreement, this is never recommended. An attorney should be engaged by the client to draft an agreement that complies with the business arrangement desired by the partners.

Given liability concerns, the LLC formed by multiple owners and taxed as a partnership has become more popular in recent years for closely held businesses in which the partners are not limited liability entities themselves such as corporations. Since the tax treatment of the partnership can be obtained by the LLC form, while providing limited liability, it is typically recommended over the general-partnership form. Professionals should be aware, however, that some states do not allow LLCs, even those taxed as partnerships, to avoid the state-level corporate (business entity) tax. An examination of the state rules affecting the proposed entity should be considered before making the entity decision.

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[2] The 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) created rough parity between corporate and noncorporate pension plans. However, corporate benefits were superior to noncorporate benefits in the 1960s, creating incentives for professionals to lobby state legislatures to permit a corporate form that did not violate public policy.

[3] Section 7701(a)(2) contains a similarly expansive definition, to include a "syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization." Thus, the terms that the owners attach to the entity are not controlling. Final regulations issued under §7701 and effective January 1, 1997, allow the owners to elect to treat an unincorporated organization (with at least two members) as an association or a partnership.

Limited Partnership

A limited partnership is a partnership in which at least one of the owners is a limited partner and at least one owner is a general partner. Limited partners are generally liable only for any amounts that they have agreed to contribute to the entity under the certificate of limited partnership. Prior to the advent of LLCs, various limited partnership-type structures were created in order to obtain partnership tax treatment while attempting to provide other corporate characteristics. Under the regulations prior to the check the box rules now in place, obtaining partnership treatment was dependent on the entity failing a test based on the number of corporate characteristics possessed by the entity.

States typically base their limited partnership rules on some form of the Uniform Limited Partnership Act which will require that to obtain liability protection, limited partners must not participate in management of the partnership. Likewise, to obtain this protection, states typically require some type of registration. In order to obtain limited liability protection for all owners, a structure in which the general partner is a corporation and in which all other partners are limited has been employed. In these cases the states will typically require that the corporation have some minimum capitalization in order to prevent abuse.

The inability of the limited partner to participate in management worked to reduce the usefulness of the traditional limited partnership for many types of businesses. However, businesses such as real estate and natural resources have flourished in this form. These structures typically consist of a general partner who operates the activity while obtaining capitalization from owners who desire the flow-through treatment of income and losses. Another option that has been employed in some cases is the bifurcation by a partner of his or her interest. In other words the partner owns both a general and a limited interest. The ordinary income share for the limited interest would not be subject to self-employment tax. However, the general interest in this strategy opens the partner to liability risks. The self-employment tax issue will be covered in more detail later in this book.

The family limited partnership (or family LLC) has become increasingly popular as an estate-planning tool. Care should be taken with regard to the specific assets placed into the entity. Likewise the donor should not be considered as having never parted with the assets, and any discounts claimed for estate and gift-tax purposes should be reasonable based on the facts.[4]

Limited Liability Company (LLC)

An LLC is an entity created under state law. Currently, all states have an LLC statute, although professionals may not be able to operate in the LLC form in all states. Where this is allowed, liability risk based on the owner's actions, such as malpractice or negligence as a professional, are unlikely to be protected.

Members of an LLC are generally liable only for amounts contributed to the entity. However, professionals operating in the LLC form will be liable for their own acts of misconduct as well as the actions of anyone under the control of the LLC member, which is similar to the LLP form in the subsequent section. LLC members, like partners in a partnership, may also

[4] Legislative proposals have been entertained that would limit the ability to claim discounts within family groups.

agree to assume liability outside of the operating agreement, such as a guarantee of a debt of the LLC.

LLCs are still relatively young entities and some practitioners are wary of them because of limited familiarity. Many professionals will be more comfortable with the corporate form since there has been a long time period in which state courts have established a body of law which does not yet exist for LLCs.

An LLC is a creation of state law, but it is not an incorporated entity. As such, under the federal tax regulations, it defaults to partnership tax status if there is more than one owner. While the LLC can choose to be taxed as either an S or C corporation, this is typically not done. As noted previously, this should not be done without a good reason. The partnership tax form allows much more flexibility should business conditions change. Also, the LLC operating agreement needs to be written in such a way that it would not violate the S corporation rules if this status is elected. Given the relatively new nature of LLCs, most professionals are likely to recommend forming as a corporation if either C or S corporate status is desired for tax purposes.

Another area of concern with LLC practice is the self-employment tax treatment of the earnings of the entity. While this has been clearly defined for the traditional general and limited partnership cases, the LLC taxed as a partnership is still open to quite a bit of debate. This will be covered in more detail later in the book.

Limited Liability Partnerships (LLPs)

LLPs are more readily available for professionals, and an existing general partnership may convert to an LLP with minimal paperwork in most states. The LLP offers partners liability protection similar to that of limited partners but with the ability to participate in management. In many states, the liability protection does not extend to contract claims against the entity and general tort liability, although partners do have vicarious liability protection for acts of professional misconduct.[5]

LLPs are basically partnerships for state law purposes. It is generally quite easy to convert an existing state law partnership to an LLP. In contrast, conversion of a state law partnership to an LLC would typically require termination of the partnership and creation of a new LLC although the federal tax implication would be similar assuming that the conversion maintained exactly the same ownership levels.

Disregarded Entities

A disregarded entity may be either a single member limited liability company (SMLLC) or a qualified subchapter S subsidiary (QSub). A SMLLC may be owned by any type of taxpayer. A QSub must be wholly-owned by an S corporation. An election must also be made to establish a QSub as a disregarded entity. An SMLLC is, by default, a disregarded entity. All states now provide for an SMLLC; a QSub is a fiction of federal tax law and may be formed (under corporate law) in any state.

[5] LLCs generally do offer protection from contractual and general tort liabilities of the entity.

Use of an Entity

Before considering which of the available entity choices would be most appropriate for a particular situation, it is first necessary to ask, why is a separate entity desirable? The most simple form of conducting a business or investment activity is the sole proprietorship. However, the vast number of businesses operated in some other form suggests that the proprietorship may be too simple to satisfy the goals of a particular situation.

Among the reasons to use a separate entity are:

- *More than one owner is desirable or necessary*—A proprietorship, by definition, has only one owner. Entities may have more than one owner, although many corporations in the U.S. have only one owner, and LLCs may have only one owner. Even in cases in which there is only a single owner, liability concerns may constitute sufficient reason to create an entity. Nonetheless, if there is to be more than one owner, a separate entity is a necessity.[6,7]

- *Separation of ownership from control*—In some cases, it may be desirable to have investors who have ownership stakes in a business but who have no management authority. An entity may be used to establish the rights of the parties consistent with the objective of separation of ownership from control. For example, the shareholders of a corporation need not participate in management. Corporate officers are generally vested with the responsibility of managing day-to-day affairs of the corporation, and the board of directors is charged with the responsibility of managing long-term affairs of the corporation. Similarly, limited partners do not participate in management because to do so would risk loss of their protected status as limited partners. Members of an LLC may be designated as managing or nonmanaging members.

  An entity may allow for multiple classes of ownership rights with different voting rights and different rights (or priority) to distributions. If an S corporation is employed, separate voting rights are permissible, but a second class of stock with respect to distributions is not allowed.

- *Ease of raising capital*—Because an entity allows for separation of ownership and control, investor capital may be raised by selling interests in the entity. Generally, corporate stock or limited partnership interests will be sold because they permit passive

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[6] A husband and wife who own a business may use the proprietorship form. However, if a separate entity is desired, and if that entity requires more than one owner, a husband and wife may be considered as separate owners for state law purposes. See Tower, 327 US 280 (1946), for an analysis of when a husband and wife may be treated as partners in a partnership. If the husband and wife live in a community-property jurisdiction, and are the only owners of an LLC, the IRS will respect the entity as a disregarded entity if that is how the spouses report its operations. Alternatively, if the spouses treat the entity as a partnership and file a partnership tax return, the IRS will respect that classification. See Rev. Proc. 2002-69, 2002-2 CB 831.

[7] Section 8215 of the Small Business and Work Opportunity Act of 2007 amended §761 by adding a provision that generally permits a qualified joint venture whose only members are a husband and wife filing a joint return not to be treated as a partnership for federal tax purposes. Under the provision (which is elective) all items of income, gain, loss, deduction and credit are divided between the spouses in accordance with their respective interests in the venture, and are reported by each spouse as a sole proprietor. Thus, just as in community property states (see preceding footnote), married couples living in common-law states now have expanded tax planning opportunities.

investment and limit investor's liability. However, LLCs may also be used with an operating agreement that designates a member manager and nonmanaging members.

- *Protection from liabilities*—Perhaps the single reason most often cited for use of an entity is protection from liabilities. Corporations, limited partnerships, LLCs, and LLPs may be used to shield owners from liability. However, some liability protection may be illusory if, for example, outside creditors demand and obtain personal guarantees from the owners. Similarly, for whatever amounts have been contributed to the capital of the business, they are subject to the business risk of loss of capital. Finally, the availability and cost of insurance as an option should be evaluated before the entity choice is determined solely because of liability concerns.

  Liability protection must be carefully examined with the assistance of an attorney. Certain risks may not be avoided (for example, contract risk in some LLPs or protection from creditors who demand personal guarantees), and risks may be best avoided in some way other than by choice of a particular entity (such as by insurance).

  Another use of the entity may be to simply hold property rather than formally operate as a business. The SMLLC and the LLC taxed as a partnership are increasingly employed to hold property in order to limit the risk of loss to the property held in that particular entity. Once again, consultation with an attorney is recommended in determining the optimal structure in which to hold property for liability purposes.

Case Studies

The chapters in this book will each contain a series of cases that can be used to demonstrate and reinforce, in a real-life setting, the concepts that have been discussed in the chapter. Each case contains a fact pattern which is then followed by a discussion. For the best learning effect, it is recommended that the reader attempt to analyze the case first, without reviewing the discussion. The discussion should then be reviewed.

These case studies illustrate situations in which a practitioner may suggest the use of an entity where the client would not be expected to see a need for one. That is, if a client proposes to operate a particular business, the choice of entity question often arises in the client's mind. Clearly the key is that the client discusses the entity decision with the professional prior to formally creating or operating an entity form.

The cases in this chapter focus on one key issue that will drive the choice of entity selected. Some of these may already be familiar to the reader and will serve as a review. As the material progresses, other factors will be considered in subsequent cases.

Case Study 1-1: Creditor-Protection Strategies

Facts

The Richards family has a variety of real-estate holdings. One of the children has encountered some financial difficulties and is concerned that his share of the family's real estate holdings may be subject to the claims of creditors. The family has approached you to discuss methods of protecting the assets of this family member.

Discussion

[The reader should note that the discussion below involves significant legal issues that are not within the expertise of a CPA. Before implementing the suggestions made in this case study, legal counsel should be consulted.]

A limited partnership may be an effective method of guarding the assets of the family member to the greatest extent that such protection may be available. The family member should transfer his assets to a limited partnership in exchange for a limited partnership interest. [Note that not *all* family members have to make such a transfer.] If the creditors of the limited partner seek to obtain the assets represented by the limited partnership interest, two things that could generally occur are

1. If the limited partner is willing to assign his interest to the creditor, the partnership agreement should state that an assignee of a limited partnership interest does not become a partner without the consent of all of the other partners. The assignee would then not obtain all of the rights of a partner.

2. If the limited partner is not willing to assign his interest, the creditor would be limited to obtaining a court-ordered "charging order." Such an order would direct the partnership to distribute to the creditor any distributions that would have been made to the limited partner. The creditor holding a charging order may be taxed on any income allocable to the limited partnership interest. If the creditor is subject to income tax on distributive-share items, but cannot receive any distributions unless the general partner(s) chooses to make such distributions, the creditor may be more likely to negotiate a settlement of the debt with the limited partner. See Rev. Rul. 77-137, 1977-1 CB 178, for an example of an assignee-partner being taxed on the income attributable to the partnership interest. However, note that the ruling concludes that the assignee had acquired "substantially all of the dominion and control" over the interest. This is a factor that may be lacking in a charging-order situation.

The use of a limited partnership for the purpose of asset protection is a legal issue that requires the assistance of an attorney. This case study is not intended to provide legal advice, but it is instead the presentation of a commonly used idea for asset protection. It is also necessary to note that a transfer to a limited partnership that occurs when the creditor is about to attach the property transferred to the partnership may well be voided as fraudulent. A transfer may be deemed fraudulent if it is made with the intent of delaying, hindering, or defrauding the creditor.

Use of a limited partnership as an asset-protection device may be very effective, however, if it is done before the transferor is insolvent or in financial distress. This is because the transfer may run afoul of a fraudulent conveyance statute and the transfer may then be set aside.

Case Study 1-2: Protecting UTMA Assets from a Minor Child

Avoiding Transfer of Assets to a Minor Following Termination of a UTMA Transfer—Transfers under the Uniform Transfers to Minors Act (UTMA) will allow a parent to qualify a transfer to a minor child for the present interest annual exclusion from the gift tax and to also shift any income from transferred property to the child. However, the child receives the property upon

attaining the age of majority, which is usually eighteen or twenty-one. It may be possible to use a limited partnership to avoid a transfer of UTMA assets to the child upon majority.

Facts

Hank Golter transferred $200,000 to his minor child Jeff under the Uniform Transfers to Minors Act (UTMA). Under controlling state law, Jeff will acquire all of the custodial assets when he reaches age 18. Jeff is currently age 15 and has had some substance abuse problems. Hank is becoming increasingly concerned about Jeff acquiring substantial assets in three years. Hank's brother (Jeff's uncle) is the custodian. Hank wisely chose someone other than himself to be the custodian because if Hank were named custodian he would have all custodial assets included in his gross estate if he died before the custodianship terminated. This is because the retained right, as custodian, to determine the enjoyment of the UTMA assets will invoke §2038 if Hank dies during the term of the custodianship. Section 2036 may also require inclusion of the custodial property in Hank's estate.[8]

Discussion

[The reader should note that the discussion below involves significant legal issues that are not within the expertise of a CPA. Before implementing the suggestions made in this case study, legal counsel should be consulted.]

Lifetime gifts of money or property to minor children can be an effective method of reducing the donor's estate by taking advantage of the present interest annual exclusion from the gift tax. However, qualifying the transfer for a present interest requires some planning. A UTMA transfer will qualify for the annual exclusion even though the child cannot obtain enjoyment of the property until the age of majority. Although the UTMA is quite simple to deal with, it has the disadvantage of placing assets in the hands of a child at a relatively young age.

Hank's problem with Jeff is not uncommon. Many parents who made UTMA transfers when their children were quite young and seemingly innocent become concerned about what the child might do with the assets after attaining the age of majority. Years ago a newspaper had a story about a 21-year-old who acquired $2 million from a trust established by his parents, and who then spent all of the funds within three weeks of receipt.

Variation of This Fact Pattern

The fact pattern involves a UTMA account that has already been established, with the focus on how to minimize Hank's concerns. A family limited partnership may be a wise choice *at the time that the custodianship is first established*. Rather than transferring assets directly to the custodianship, the family could first transfer assets to a limited partnership and then transfer the limited partnership interests to the custodianship. When the child reaches the age of majority, he or she will receive a limited partnership interest. This technique would avoid any risk that the custodian has breached a fiduciary duty by transferring assets held in custodianship into a limited partnership.

[8] See *Estate of Russell H. Varian*, 22 AFTR 2d 6022 (9th Cir. 1968).

It may be possible for Hank to establish a family limited partnership to solve his problems with Jeff's impending attainment of the age of majority. Hank's brother, as custodian under the UTMA, would have the authority to transfer the custodial assets to the partnership in exchange for a limited partnership interest. This transfer would represent an investment of the custodial assets, which is within the powers of a UTMA custodian. Hank would also transfer substantial assets in exchange for a general partnership interest. Hank would then have the continued authority to control the assets that would have passed directly to Jeff at age 18. Jeff will, of course, acquire the limited partnership interest at age 18. However, Jeff would be quite restricted in his ability to realize cash from the investment.

It would be necessary for Hank's transfer to the partnership to be substantial to minimize the risk that Jeff may charge his uncle with a breach of his fiduciary duty as a UTMA custodian. The custodian has a duty to administer the custodial property in the best interests of Jeff. There are two reasons why a breach of fiduciary duty would not be expected to be a significant concern under these facts:

- Jeff may not know that the funds exist or, if he does know, he may not be aware of the exact form in which the assets are held. When he receives a limited partnership interest at age 18, he would be expected to be quite grateful and not seeking to file a claim against his uncle.
- The custodian has a duty to invest assets in the best interests of the minor. Given the facts of this case study, it may readily be argued that it is not in the best interests of the minor to receive substantial assets at age 18. Because the child has substance abuse problems, a custodian could argue that it would be a breach of fiduciary duty to not take some actions to protect the assets from the minor's immediate possession at age 18.

If the client lives in a state that has adopted the UTMA, a limited partnership interest should be a permissible investment in the custodianship. It is possible that states that are under the Uniform Gifts to Minors Act (UGMA), only South Carolina and Vermont when this case was written, may not permit a limited partnership interest to be held in a UGMA custodianship. Securities may be held in the UGMA, and if the limited partnership interest may be freely transferred, it should qualify as a security and thus be a permissible UGMA investment.[9] This issue must be considered in consultation with an attorney familiar with local law.

Case Study 1-3: Changing the Situs of Real Property

Shift the situs of real property—Real property is subject to the laws of the situs jurisdiction. Personal property is subject to the laws of the jurisdiction in which the owner is domiciled. If it is preferable to shift the situs of real property, a transfer of that real property to an entity in exchange for an interest (which is personal property) may achieve this objective.

[9] Under pre-1997 tests for association status of a limited partnership, free transferability of interests was a potential concern. However, following the issuance of final §7701 regulations effective January 1, 1997, the risk of association status disappears because the entity may simply be a partnership by filing a Form 1065.

Facts

Heidi is a real estate investor who has land holdings in five western states. Heidi has learned that her resident state has more favorable creditor protection than the other states in which her real property investments are located. Heidi has also planned to give her three children whatever property she holds at her death, and she would like to avoid probate in all of the states in which she owns land. Heidi is married and has made separate provision for her husband.

Discussion

[The reader should note that the discussion below involves significant legal issues that are not within the expertise of a CPA. Before implementing the suggestions made in this case study, legal counsel should be consulted.]

The situs of real property is determined by where it is located. The situs of personalty is determined by reference to the residence of the owner.

Heidi may consider establishing a partnership or LLC in her home state to hold all of her real property. Because a partnership or LLC interest is personal property, the laws of Heidi's home state will control the partnership or LLC interests. Thus, Heidi may change the jurisdiction of the real property for creditor protection purposes. At her death, the children will receive partnership interests and there will be no need to probate her will in the other states. Heidi's husband could be the other partner or LLC member, or she could establish limited partnership interests when the entity is formed and begin a program of giving interests to the children.

Putting real property that is likely to appreciate into an S corporation has a number of potentially unpleasant consequences. If it is ever desired that the entity be liquidated, the appreciation would be subject to tax on liquidation. Also, the ability to make a §754 election is only available to entities treated as partnerships for federal tax purposes and is not possible in the case of an S corporation.

Case Study 1-4: Minimizing Risk of Dealer Status

Facts

Jackson Bullock owns 104 lots in an area of town known as Deep Forest. Jackson purchased the lots approximately four years ago at a cost of $4 million. Deep Forest is currently being developed for single-family housing, and Jackson has learned that he can sell the lots for an average price of $100,000. Thus, he anticipates a total sales price of $10.4 million, although it is clear that it will take approximately three years to sell each of the lots individually. Jackson has not engaged in any previous real estate sales or development activity. Many of the lots are contiguous, and he did incur some costs to subdivide several tracts. He has not engaged in any sales activities to date.

Discussion

Jackson's anticipated profit from the sale of lots ($6.4 million reduced by costs of sale and subdivision costs already incurred) will very likely be classified as ordinary income if he sells 104 individual lots over a three-year time period. Jackson will then pay the highest statutory tax

rate on ordinary income (not to mention state tax) on all gains. He will also be ineligible for a like-kind exchange if he wants to defer any of the gain.

The reason for the above conclusions is that Jackson will be deemed to have held the property as a dealer rather than as an investor. Section 1221(a)(1) defines a capital asset by exclusion, providing, in part, that a capital asset shall not include any property held primarily for sale to customers in the ordinary course of a trade or business. Section 1231(b)(1)(B) similarly excludes from the definition of a §1231 asset any property *held primarily for sale to customers in the ordinary course of a trade or business*. Thus, if Jackson is found to have held his lots for that prohibited purpose, any gain from the sale of the lots cannot be either capital or §1231, and will instead be ordinary income.

Section 1031(a)(2)(A) denies like-kind exchange treatment to the sale or exchange of any property that is held for sale.

Whether a taxpayer has held real property primarily for sale to customers in the ordinary course of a trade or business is a factual question.[10] The courts have applied a *factor* test to determine whether the requisite motive has been met, and the frequency and continuity of sales has often been regarded as the most important factor in determining the purpose for which property has been held.[11]

If Jackson attempts to sell 104 lots over a three-year period, it is quite likely that he will be regarded as a dealer under the factor tests developed by a variety of courts.[12] In contrast, if Jackson could sell all of his lots in a single transaction, it is likely that he will be regarded as an investor. This is so because he would have a four-year holding period when no sales occurred (which strengthens his appearance as an investor) and he will have neither frequent nor continuous sales activities. He will also have limited sales efforts for a single sale, which is another important factor in dealer-investor classification.

Jackson's problem, of course, is locating a buyer for a single sale. Another problem is that a buyer in bulk will discount the price paid for the lots so that a profit can be realized from the sales activities to individual buyers. Jackson can solve both of these problems by employing the following strategy:

1. Jackson should form a new corporation in which he owns 100 percent of the stock. The corporation should make a timely S election to avoid two levels of tax.
2. Jackson should sell his 104 lots to the corporation for a price *less than the $100,000 per lot that can be realized from individual sales over a three-year period*.
3. The corporation should then sell individual lots over a three-year period at $100,000 per lot. The corporate profits will be ordinary income because the corporation will be a dealer.

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[10] See Byram, 705 F.2d 1418 (5th Cir. 1983).
[11] See Biedenharn Realty Co., 526 F.2d 409 (5th Cir. 1976).
[12] The dealer-investor issue has been one of the most frequently litigated areas of tax law, and there are no clear guidelines distinguishing a dealer from an investor. This case study makes no effort to delve into the depths of analysis required to properly reach a conclusion of Jackson's status. The purpose is to address how Jackson dresses up his facts to improve his chances of achieving investor status.

Where does the money come from? Ideally, it should be a cash sale, including one financed by a third-party lender. However, that failing as a possibility, it could be a seller-financed transaction. Section 351 treats stock as the only permissible consideration. Thus, receipt of a security issued by the corporate purchaser will still allow gain to be recognized, which gain should be capital for the reasons explained in this case study. However, if the corporate debt may be classified as equity using the principles of §385, the IRS may successfully argue that the transfer is a nontaxable contribution to capital or a §351 exchange. Gain from a seller-financed sale should be eligible for installment reporting by cash-basis entities under §453, although the related-party resale rules would apply.

Jackson should qualify as an investor when he sells all lots in a single transaction. It matters not that he is selling to a controlled corporation. It is important to note that *he cannot sell to a controlled partnership, including an LLC that is taxed as a partnership*. Section 707(b)(2) states that any gain realized from the sale of property between a partner and a controlled partnership (one that is owned, with attribution, more than 50 percent by the seller) will be ordinary income *if the property is not a capital asset in the hands of the partnership*. The 104 lots would not qualify as a capital asset to a partnership formed for the purpose of selling those lots. Thus, Jackson's gain from a sale to a controlled partnership would be ordinary and nothing would be accomplished by creating the entity.

Other Uses of This Strategy

- If the property to be sold is depreciable, it may still be sold to the corporation. However, the seller must own no more than 50 percent of the corporation to avoid §1239. Thus, some of the development profit must be shared with an unrelated party. This caution may apply to a condominium conversion where some units will continue to be rented.
- The gain realized from the sale to the corporation may be eligible for deferral under §1031. A tax deferred exchange will allow the taxpayer to maximize sale proceeds available for reinvestment in real property. The sale could be structured to qualify for a forward deferred exchange as provided in §1031(a)(3) and the regulations promulgated under that provision. However, the related-party exchange provisions of §1031(f) should be reviewed, particularly the indirect related-party rules of §1031(f)(4).

Section 707(b)(2) does not apply to a corporation (be it an S corporation or a C corporation).[13] However, §1239 does apply. Section 1239 treats as ordinary income, and not as capital or §1231 gain, any gain realized from the sale of *depreciable property* to a controlled corporation or partnership.[14] Because the lots held by Jackson are not depreciable, this provision does not apply. Thus, the gain from the sale to the corporation should be capital.

It is important to avoid attempts to receive too much advantage from the strategy of selling to a controlled corporation. For example, it is tempting for the taxpayer to sell to the corporation for $10.4 million, the expected sales price of all of the individual lots, so that the corporation has no

[13] Section 707(b)(2) also does not apply to an LLC that has elected to be an association. However, this exception is expected to be of limited utility in implementing the idea suggested by this case study.
[14] Section 1239(c)(1)(B).

ordinary income to report. Because the corporation is regarded as a third party with respect to the taxpayer, the sales price should be set at whatever price would be reasonable for a bulk sale to a third party.

Note that in this case the objective is to sell the lots to an outside buyer rather than maintain an interest in the property or pass the property through an estate. Based on this goal, the concerns about the use of the S corporation form discussed in the previous case would not prevent the use of an S corporation here.

Case Study 1-5: Selling a Principal Residence to a Controlled Entity

Facts

Ben and Jeri Eiscreme purchased their first home for $100,000. Ben and Jeri have listed the home for $165,000 on the recommendation of a local real estate agent. Due to a job transfer, Ben and Jeri were forced to vacate the home and move to a new city, where they purchased a new home for $212,000. To defray the costs of carrying two residences, Ben and Jeri rented the former residence while they continued attempts to sell. The home has been on the market for 34 months in total, and it is now 30 months after Ben and Jeri purchased and moved into their new home. Ben and Jeri understand that (under §121) they must sell the former home within the next six months to exclude the (expected) $65,000 gain.[15]

Discussion

The facts of this case study may be used to discuss several ideas involving a sale of a principal residence to a controlled corporation. Section 121 requires that the taxpayer has owned and used the property as a principal residence for two of the five years before the sale. Thus, if the home is sold within the next six months (Ben and Jeri vacated the residence 30 months ago—a sale within the next six months will still allow them to meet the *two-of-five test*), Ben and Jeri could exclude the expected gain.

Ben and Jeri should immediately (definitely within the next 6 months) take the following actions:

1. Form a new corporation owned 100 percent by Ben and Jeri. The corporation should make a timely S election to avoid two levels of tax. This entity could also be an LLC, although there may be some issues with this form. The remainder of the discussion will refer to an S corporation.[16]

2. Sell the former residence to the new corporation for fair market value.

The (assumed) $65,000 realized gain from the sale to the controlled corporation may be excluded using §121. While this may appear surprising, the IRS has so ruled in Letter Rulings 8350084 and 9625035. Both rulings dealt with old §1034 but should also apply to new §121.

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[15] It is assumed that there has been no unqualified use of the property in the past that would result in a limitation of the gain that could be excluded. It is also assumed that there has been no prior rental use which would have resulted in depreciation.

[16] Care should be taken if this is made to an LLC. Recall that an SMLLC is a disregarded entity. This raises the issue of how one sells something to himself or herself. In this case, the problem may be avoided by having both spouses be members in the entity.

Note that the corporation will have a cost basis of $165,000. If the corporation later sells the home, regardless of when that sale may occur, the only gain that will be recognized will be any appreciation that occurs *after* the sale to the corporation. If the corporation continues to rent the residence, it will have a higher depreciable basis.

A few "loose ends" should be mentioned to clarify use of this strategy:

- Under the two rulings cited above, the IRS conceded that §1034 may be used to defer the gain from the sale to the controlled entity. However, it also contended that §1239 will result in future gain recognized from the sale of the new home being treated as ordinary income. Section 1239 characterizes gain as ordinary, and not capital or §1231 property, when depreciable property is sold to a controlled entity. In the above example, any part of the $65,000 gain that is recognized from the sale to the controlled entity would be ordinary. Because §1034 allows this gain to be deferred, the IRS contends that the first $65,000 of gain ever recognized from the sale of the new home will be ordinary. There is no explicit authority for the IRS view. However, because §121 allows an exclusion of gain, there should no longer be a need to ever deal with this part of the IRS ruling.
- The transaction should be clearly documented as a sale, with an appraisal obtained and, preferably, outside financing. With respect to seller-financing, see the discussion in the text box in Case Study 1-4.
- Unlike Case Study 1-4, the sale may be to a corporation or an LLC. This is so because the gain will be excluded, so the character of gain is not relevant. However, the entity chosen would affect the tax treatment of the earnings created while the property was held by the entity. Also, should the entity still be held at the time of death, estate tax implications such as a basis step-up might favor the LLC. On the other hand, the ability to possibly sell the stock of a corporation holding the property rather than the property itself may be advantageous in some cases.

Because Ben and Jeri want to rent their former residence, a sale to a controlled corporation (or LLC) may permit a basis adjustment to the amount of the sales price ($165,000) at no tax cost because of the exclusion.

Case Study 1-6: Valuation Discounts Using Partnerships

Facts

Grandma Roses, a widow, owns real property valued at $2 million, which is appreciating at the rate of 8 percent per year. Grandma would like to give some of the property to her children and some to her grandchildren. She wants to minimize the gift and generation-skipping taxes that would be due on such transfers. She also wants to continue to control the property until her death.

Discussion

Grandma Roses should consider creating a family limited partnership to hold the real property. Grandma could continue to control the property by retaining a general partnership interest. By transferring limited partnership interests to the children and grandchildren, she should qualify for

valuation "discounts" for purposes of the gift and generation-skipping (for transfers to the grandchildren) transfer taxes, and she could also take advantage of the annual exclusion.[17]

Family limited partnerships (FLPs), so-called because the partners are members of the same family, have long been used for business and tax purposes. Because limited liability companies (LLCs) are a relatively new invention of state law, they have attracted less attention by tax advisors seeking valuation discounts for their client's assets. An increased understanding of the LLC and the long-awaited issuance of proposed regulations permitting unincorporated entities with at least two members to be classified as a partnership for federal income tax purposes may enhance the use of the LLC as an estate-planning tool. However, whether the CPA recommends use of an FLP or an LLC, it is essential to document a business purpose for creating the entity.

When assets are transferred to an FLP, it is often stated that a valuation discount may be obtained. For example, if Grandma transfers $2 million of real property to an FLP and gives a 30 percent interest to one child, the child's interest will be valued at less than 30 percent of $2 million, perhaps 35 to 50 percent less. Technically, there is no actual discount in the value of the child's interest—it is worth fair market value. However, the inability of the child, as a limited partner, to control the property, to sell his partnership interest, or to compel a liquidation of the partnership with a distribution of the child's share of the property will mean that a willing buyer would pay less than $600,000 for the interest. Grandma may then continue to control the property, shift any appreciation attributable to the child's interest out of her estate, and also obtain a gift tax valuation for the child's interest that is less than the net asset value represented by that interest.

LLCs formed before 1997, like FLPs, must have been structured to have no more corporate characteristics than noncorporate characteristics if the entity was to be recognized as a partnership for federal income tax purposes. Two of these corporate characteristics are free transferability of interests and continuity of life. Both FLPs and family LLCs generally sought to avoid free transferability of interests so that ownership interests cannot be transferred outside of the family without majority consent. An LLC could avoid the corporate characteristic of free transferability if members owning more than 20 percent of the interests could not confer full ownership rights on a transferee without majority consent of the LLC members. Continuity of life can be avoided by requiring majority approval for continuation of the entity following certain dissolution events such as the death, insanity, bankruptcy, retirement, resignation, or expulsion of a member-manager. Entities formed before 1997 will continue to use the same classification that they claimed as of December 31, 1996, unless they lacked a reasonable basis under the pre-1997 rules.

A significant issue to address when suggesting use of an FLP or LLC is which assets should be placed into the entity. Regulations issued in January 1995 suggested that the IRS may challenge the use of FLPs purely for investment assets, such as marketable securities, life insurance policies, or a vacation home. The examples that supported such a challenge were removed from the regulations, but IRS officials have made it clear that they will challenge inappropriate use of the partnership form, including attempts at valuation discounts. A business purpose for the

[17] See *Harwood*, 82 TC 239 (1984), aff'd 786 F.2nd 1174 (9th Cir. 1986); *Knott*, TCM 1988-120; and *Moore*, TCM 1991-546, for examples of cases that held that discounts permitted for stock in closely held corporations apply to partnerships as well.

transfer of assets to the FLP or LLC is essential to successfully using these entities for transfer tax savings.

The importance of the association test for FLPs and LLCs formed after 1996 has disappeared effective January 1, 1997. The IRS issued regulations that provide a default rule that an unincorporated entity with at least two members will be a partnership. The enactment of these regulations may provide an impetus for states to permit LLCs to provide for less flexibility to dissolve the entity upon a dissolution event, thereby creating the corporate characteristic of continuity of life. Such a change may increase the discount available for an LLC interest because the member's right to dissolve the entity and receive assets is reduced.

The IRS has attacked FLPs when there is no apparent business purpose for the entity (see, for example, FSA 2001434004). The Tax Court has refused to ignore the separate existence of a validly formed state law partnership, even when the taxpayer has failed to follow normal formalities associated with the entity.[18] Nonetheless, it is suggested to document a business reason for creation of the entity.

The existence of a business purpose was helpful to the taxpayer in *Stone*, TC Memo 2003-309, where the IRS unsuccessfully sought to include FLP assets in the decedent's estate under Section 2036. More recently, the Tax Court has said that a legitimate and significant nontax reason to establish the FLP is a condition to qualify for the bona fide sale exception to Section 2036.[19]

The CPA, generally with the assistance of an attorney, should carefully document the business purpose for transfer of assets to an FLP or LLC. Proper management of family assets, including liability protection, centralized management and retention of assets within the family, and involvement of children in a family enterprise may be business reasons for the transfer. Protection from creditors, who may be limited to obtaining a charging order against a limited partnership interest, may also be an important reason for the transfer. Consolidation of control over assets and avoidance of ancillary probate for out-of-state real property holdings may also be a reason for use of an FLP or LLC. These reasons may apply to marketable securities as well as to business assets. However, it is important to avoid use of an FLP or LLC solely to obtain a valuation discount when no business reason for the transfer of assets can be justified.

Proposals exist that include an additional category of restrictions (termed disregarded restrictions) that would be ignored in the valuation of an interest in a family-controlled entity transferred to a member of the family, when subsequent to the transfer the restriction will lapse or may be removed by the transferor or the transferor's family. In this case, the interest will be valued using assumptions to be provided in the regulations in place of the disregarded restrictions.

Disregarded restrictions would include the following:

- Limitations on a holder's right to liquidate that holder's interest that are more restrictive than a standard identified in regulations

[18] *Strangi*, 115 TC 478 (2000); and *Knight*, 115 TC 506 (2000).
[19] *Bongard*, 124 TC 95 (2004).

- Any limitation on a transferee's ability to be admitted as a full partner or holder of an equity interest in the entity

In testing removal potential, certain interests held by a charity or other non-family members may be deemed as held by the family per the rules to be provided in the regulations. Safe harbors are also to be provided in the regulations.

Chapter 2

Entity Formation

Overview

The issue of entity formation can actually have an impact on the form of entity chosen. As discussed in the Preface, the structure that suits the owner's needs the best during the years of operations and at exit or transfer of the business will typically govern the entity form chosen. Luckily, both corporations and partnerships (and other entities that can choose to be taxed as either) can be formed in a tax-free (actually tax-deferred) manner. However, more structure is required to meet the corporate tax-free formation under §351 than is required on the contribution of property under §721.

Correct choice at the beginning is a key to minimizing both tax and legal issues during the years of operations and at exit. Assuming that there are no legal reasons for preferring corporate over partnership or LLC structure, the partnership or LLC form will generally provide more flexibility in the tax world. This reasoning is based on the ability to convert to the corporate form from the partnership form without a tax hit as long as the requirements of §351 are met. However, the move from a corporation to a partnership would involve a corporate liquidation and a partnership formation, and the corporate liquidation portion would typically have a tax cost.

In this chapter, we will address the consequences of forming the different types of entities, and explain why a particular form may be best suited for a particular situation. Once again, after discussing the tax law governing the formation of entities, we will rely on case studies to reinforce many of the points. The discussion in this chapter, and the book as a whole, focuses on the federal tax issues. State entity issues, both legal concerns and costs, should also be considered prior to selecting the entity form.

How Difficult Is It to Form an Entity?

The answer to this question depends on several factors, the most significant of which is the type of entity to be created. A general partnership may be formed with no professional or filing fees at all. Of course, that is not the advisable way to form a general partnership, but it can be, and is, done with no written documentation at all.[20] In contrast, a limited partnership must file a certificate of limited partnership with an appropriate state agency or official to protect the limited liability of the limited partners (that is, to give public notice of their status as limited partners). It

[20] Of course, the business may be required to obtain withholding identification numbers and satisfy other requirements for state and federal filings applicable to any business. However, the same filings would be required for a sole proprietorship; changing to a general partnership need not add any complexity unless the parties see the benefits of formal, written documentation of their agreement.

is advisable, however, for both general and limited partnerships to have written agreements to define each partner's rights and duties.

Corporations are created pursuant to state law. Generally this requires the assistance of a business attorney, although many self-help kits are available in the marketplace. Limited liability companies must also be created using the formalities of state law, thereby raising the cost of formation. Some advisors caution that LLCs can be more expensive to form than corporations because the operating agreement may need to be quite complex to deal with issues such as special allocations of tax items. The annual filing fees and state income taxes required by states also vary between the entities and across states.

As partnerships, for tax purposes, LLCs operating a business offer flexibility that cannot be matched by corporations, and it is true that taking advantage of that permitted flexibility requires a properly drafted, and perhaps costly, agreement. However, because taking advantage of the subchapter K flexibility is, in most cases, optional, the parties forming an LLC need not bear the cost of that flexibility unless they believe the benefits are of greater magnitude.

A note of caution is in order here. While it is tempting for some professionals who are not attorneys to assist their clients in drafting the corporate or partnership agreement documents, this is not an appropriate action for accountants in most states. The document preparation is considered the practice of law in most states. It is fine for a taxpayer to prepare these documents themselves, and an attorney is not a requirement although one is highly recommended. However, the accountant should not prepare these types of documents for their clients unless it is within the state's scope of accounting practice.

At this same time, it is important that the accountant review the documents prior to their submission to the appropriate state agency for the entity's creation. Many attorneys will not be versed in the federal tax issues involving a particular type of business. On the contrary, this tends to be the area of expertise of the CPA. These attorneys will typically have standard forms that are "safe" for use in that state and for federal tax purposes. These standard forms often contain language, however, that will provide for certain allocations, chargebacks, and offsets that may not be those the owners intend. For that reason it is best when the formation documents are prepared by an attorney in consultation with the CPA.

Technically, a partnership must have at least two owners. Certain states allow one-member LLCs, which are not taxed as partnerships. Instead, they are taxed as a "disregarded entity" resulting in Schedule C presentation on the individual owner's return if the owner is an individual.

Tax Consequences of Formation

General Discussion

At initial formation of an entity, it is generally possible to transfer money and property to any type of entity without any tax consequences. This result is consistent with a variety of nonrecognition provisions found throughout the tax law and is based upon the theory that no gain or loss should be recognized when a taxpayer continues an investment in an alternative form. That is, the owner is not viewed as having cashed out of the property held but rather as simply having changed his or her form of ownership of the property. The primary provisions of concern

are §351, which relates to corporate formation, and §721, which relates to property contributions to a partnership. The former provision relates to corporations and contains one key requirement that is not found in the partnership provision, specifically control. This will be discussed in more detail throughout this chapter.

Allowing for nonrecognition of gain satisfies an important tax policy objective. The tax law should not create an impediment to a taxpayer's choice of the appropriate form of doing business. Of course, to minimize potential abuses, the tax law has several exceptions to the general rule of nonrecognition of gain. These exceptions may suggest that one form of an entity is superior to another with regard to formative tax effects if there are differences in how the exceptions are applied to different entities. The next section reviews the basic rules for nonrecognition of gain from the transfer of property to an entity so that we may see how the differences can affect the choice of an entity.

It is important to remember that all entities may potentially be formed without recognition of any gain; therefore, the tax effects at formation are generally not an issue. The key exception to this rule occurs when the interests are granted in exchange for services rather than property and when contributions of property are expected to occur over multiple periods rather than at formation.

Transfers to a Corporation

The language of §351(a) states that "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control...of the corporation."

In addition, §1371(a)(1) states that all provisions of subchapter C shall apply to S corporations except where the tax law specifically provides otherwise. Because there is no provision that exempts S corporations from §351, transfers to S corporations are subject to the same provisions as apply to C corporations. This will allow for equivalent formation rules for both C and S corporations.

If stock is received in exchange for services, §351 will not apply to the service provider.[21] Instead, the service provider will be subject to §83(a) and will be required to recognize ordinary income unless the stock is not freely transferable and is subject to a substantial risk of forfeiture. Even this rule can be overcome if the service provider also provides property. It should be noted that this property contribution should be above a *de minimis* amount.

Because §351 requires that the transferors control the corporation immediately after the transfer, the existence of a service provider may jeopardize the tax-free transfer for all parties. This is because the service provider is not a transferor of property and his or her stock ownership is not counted in meeting the control requirement.[22]

Control for this purpose is defined as at least 80 percent of the combined voting power of all classes of stock entitled to vote and 80 percent (in number) of all other classes of stock.[23] If a service provider receives more than 20 percent of the stock, the transferors will not control the

[21] Section 351(d)(1).
[22] The service provider's ownership may be counted if he also transfers property provided the property is more than relatively small in relation to the value of the stock received. See Treas. Regs. § 1.351-1(a)(1)(ii).
[23] Section 368(c).

corporation and will be required to recognize all realized gain. Note that if all the non-service providers were contributing simply cash, which does not have the potential of being appreciated property, the formation would still be non-taxable to all the non-service owners.

Section 351(b) provides a boot relaxation rule, by which receipt of property other than stock will not make the transfer fully taxable (because it does not meet the solely-in-exchange-for-stock requirement), but will instead require any transferor who receives property other than stock to recognize gain equal to the lesser of the gain realized from the exchange or the fair market value of the nonstock consideration received.

Liabilities attached to contributed property can also create a tax effect in an otherwise non-taxable formation. Section 357(a) provides that the assumption of a liability of the transferor will not be treated as nonstock consideration received by the transferor. Thus, the transfer of encumbered property is generally not a concern when a corporation is formed unless the liabilities assumed exceed the adjusted basis of the property transferred. If the liabilities are in excess of the basis in the property, there will be a tax hit for the excess.

Section 358(a)(1) states that the basis of stock received in a §351 transfer shall equal the basis of any money or property transferred to the corporation, increased by any gain recognized by the transferor and *decreased* by the amount of any money received and the fair market value of any nonstock consideration received. Although §357(a) states that liability relief shall generally not be treated as nonstock consideration, §358(d)(1) states that liability relief shall generally be treated as money received. This means that the basis of stock received is reduced by any liability relief.

The stock basis determination ensures that any gain realized but not recognized in the transfer is deferred and not excluded. That is, the stock basis will be less than the value of the stock by the amount of gain deferred.

Example 2-1

Jack and Jill form the JJ Corporation by transfer of property. Jill transfers property valued at $100,000 and which has a basis of $50,000 to Jill. Jill receives stock valued at $80,000 and also receives $20,000 (which was part of the property transferred by Jack). Jill has a *realized* gain of $50,000 and a *recognized* gain of $20,000. She has deferred $30,000 of her realized gain. Jill's basis in the stock received will be $50,000, determined by adding the gain recognized to the basis of the property transferred and then subtracting the amount of money received. If Jill later sells the stock for $80,000, she will recognize the deferred gain of $30,000.

Section 358(a)(2) provides that the basis of any nonstock consideration received in exchange for property shall be its fair market value. This is logical because such boot property is received in a taxable transaction (the transferor recognizes gain in the amount of boot received) and the boot must then take a fair-market-value basis.

As mentioned previously, it is possible that the relief of liabilities may require the transferor to recognize gain. Section 357(c) requires the transferor to recognize gain equal to the excess of any liabilities transferred over the basis of the property transferred. This occurs because the basis of

stock received is reduced by liability relief. If the liabilities exceed the basis of the property transferred, the transferor's stock basis would be negative if no gain was recognized. While some tax theorists have argued in favor of the idea of negative basis, this is still not allowed. The taxpayer would recognize the gain necessary to maintain zero basis in the stock and prevent a negative basis.

Some taxpayers have attempted to use the liability provisions as a way to extract cash through the corporate formation process. They will borrow against the property to be contributed to the corporation before the time of contribution, but below the level of the property's basis to avoid the §357(c) problem just described. In order to prevent this type of abuse, §357(b) treats as boot any liability that (1) has no bona fide business purpose for being transferred to the corporation or (2) is transferred with a tax avoidance motive. Regulations §1.357-1(c) provides that if any liabilities transferred are treated as boot under §357(b), then all liabilities transferred by that transferor shall be boot. This is an extremely harsh rule (one bad apple spoils the whole bunch) and suggests that §357(b) should be avoided.

Example 2-2

Tom forms a corporation by transfer of an asset with a fair market value of $100,000, a tax basis of $50,000, and which is subject to a liability of $20,000. Tom has a realized gain of $50,000, which is the excess of the consideration received ($80,000 stock value plus $20,000 liability relief) over the basis of the asset transferred. If Tom's stock is later sold for its $80,000 fair market value (net asset value), Tom should recognize his $50,000 deferred gain. This will occur only if the basis of the stock is $30,000 ($80,000 sales proceeds minus $30,000 basis equals $50,000 gain). The stock basis will equal the basis of property transferred by Tom ($50,000) reduced by the deemed amount of money received as a result of the liability transfer ($20,000). The basis reduction is necessary to ensure that the deferred gain will later be recognized. This is because a sale of stock does not include a shareholder's proportionate share of liabilities in determining amount realized.

Transfers to a Partnership

The fact that there is no control requirement makes it easier to qualify transfers to a partnership as tax-free. This is particularly true when a transfer is made to an existing entity. The transferor may not, by himself, control the entity, which would make a transfer to a corporation taxable. It is necessary to consider whether such transfers may occur after the entity is formed because the existence of future transfers may suggest that a partnership or an LLC is advisable.

The language of §721(a) states that "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." This lack of a control requirement will allow for the admission of additional owners subsequent to the initial formation of the entity through the contribution of appreciated property without a tax hit at that time.

Section 721 has no specific statement with respect to the transfer of liabilities to a partnership. However, §752(b) notes that a decrease in a partner's share of liabilities of the partnership is treated as a distribution of money from the partnership to the partner. If a partner contributes

property subject to a liability, or if the partnership assumes a liability as part of a transfer, the contributing partner has a deemed distribution of money under §752(b). This deemed distribution occurs to the extent that the partner's share of the liability is decreased as a result of the transfer. In other words, an entering partner must examine his or her net liability position before and after the exchange for the partnership interest to determine whether there is a liability problem. Effectively, the partner may pick up liabilities of the partnership and be relieved of a share of liabilities through the encumbered contribution. These shifts of liability responsibility are treated in the partnership world as deemed money contributions and distributions.

Whether a contributing partner's share of a liability is decreased is determined under the liability-sharing rules of §752, which are specified in the regulations promulgated under §752. Basically, a partner's share of a *recourse liability*, defined as a liability for which at least one partner, or a party related to at least one partner, is personally liable. It is determined using an economic risk of loss analysis and is, therefore, typically limited to general partners. This analysis assumes that the partnership's assets, including money, are worthless, that all assets are sold for zero consideration with any resultant loss allocated among the partners, and that the creditors demand payment. To the extent that a partner must make a payment under such a scenario, that partner bears an economic risk of loss. A partner's share of nonrecourse liabilities is determined using a three-step approach that is generally favorable to the partners. This is also the type of liability that allows for a limited partner to obtain basis in partnership debt.[24]

Although a partner who contributes property with a liability to a partnership is generally much less likely to recognize gain when compared to that partner making a transfer to a corporation, there is some risk that a transfer of a liability to the partnership may result in a contribution being recharacterized as a disguised sale.[25] At one time, the relative flexibility with which the tax law treats the partnership form would permit a partner to incur a debt shortly before a transfer to the entity. The disguised sale rules create what is effectively an equivalent rule for partnerships to the §357(b) tax-avoidance liability rules. Careful planning may be required when the partnership is formed to avoid this problem.

A partner who receives an interest in exchange for services is not protected by §721. However, the proper tax treatment of the service provider is more complicated than is the case when services are provided to a corporation.

If the service provider receives a capital interest in a partnership in exchange for services, the value of the interest received must be included in the service provider's income unless it is both subject to a substantial risk of forfeiture and not freely transferable.[26] A capital interest is defined as one which allows the partner to receive a distribution of proceeds if partnership assets are sold for fair market value and the proceeds of that sale are then distributed to the partners in liquidation of their interests.[27]

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[24] While a complete discussion of the issues of liabilities incurred by partnerships and LLCs is beyond the scope of this publication, the AICPA offers a CPE course entitled *LLC and Partnership Taxation: Beyond the Basics* which provides a thorough discussion of the allocation of liabilities among partners and members.
[25] Section 707(a)(2)(B).
[26] Section 83.
[27] Revenue Procedure 93-27, 1993-2 CB 343, and Reg. §1.721-1(b)(1).

If, under local law or the partnership agreement, a partner's share of partnership assets is determined by reference to that partner's capital account, then an interest in capital confers upon the partner an immediate economic benefit similar to the receipt of corporate stock.

On the other hand, a service provider may receive a pure profits interest in the partnership rather than a capital interest. A profits interest does not entitle the partner to receipt of any proceeds should the partnership liquidate on the date that the interest is transferred. If the partnership fails to earn any profits after the date of transfer, the service provider will not receive anything from the profits interest. The pure profits interest is one in which the capital account will have a zero balance upon issuance of the interest. Because the existence and amount of future profits are speculative, there is no income recognized upon receipt of a profits interest.[28] Likewise, a liquidation of the partnership in the instant following the grant would necessarily result in this service partner receiving zero proceeds since there is no capital balance and no value for tax purposes. Instead, the partner will be taxed on his or her share of income as it is recognized through income generation by the partnership. As this income is generated, the partner will also begin to generate a capital balance. This also means that the profit and or loss percentages will not match the capital balance percentages once a profits interest has been introduced to the mix.

A partner's basis in his or her partnership interest is the basis of any money or property contributed.[29] If relief of liabilities causes a partner to recognize gain, there is no basis adjustment for the gain (note that a basis adjustment is allowed for liability relief in excess of basis if the transfer is to a corporation).[30] This is because the gain occurs as the result of the shift being treated as a distribution under §731 that is deemed to occur one moment after the contribution. Because the gain is not attributable to the contribution, no basis increase is allowed.[31] A §754 election by the partnership can allow a §734 adjustment to increase basis for this gain.

S Elections

Section 1362(a) requires an affirmative election to be made by all affected shareholders for a qualifying corporation to be an S corporation. If S corporation status is important, the election must be made on or before the 15th day of the third month of the corporation's first tax year. This two and one-half month rule is formally based on the earlier of the dates that the corporation has shareholders, property, or conducts business. In practical terms, this means that the S election should be filed immediately upon formation rather than waiting until it actually begins business. While the service has generally been extremely friendly with regard to late relief, as long as all shareholders and the corporation have reported consistently with the S rules,

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[28] Revenue Procedure 93-27, 1993-2 CB 343. This Revenue Procedure mentions three exceptions to the IRS view that no income is recognized: (1) if partnership profits are substantially certain and predictable, such as when partnership assets consist of high-grade securities or high-quality leases; (2) if the service provider sells his interest within two years of receipt; and (3) if the profits interest is a limited partnership interest in a publicly traded partnership. Proposed Regulations issued on May 24, 2005, would not change this result but would require adoption of an election to use the "liquidation approach" to valuation. Until the regulations are issued in final form, the 1993 Revenue Procedure remains in force.

[29] If gain is recognized because *the partnership is an investment company*, the contributing partner's basis is increased by the gain. This is very rare and is not separately discussed in this book.

[30] Ibid.

[31] Section 358(a)(1)(B).

it is clearly better to follow the correct procedure in the first place. For those S corporations in community property states, it should also be noted that both spouses must sign the election in order for it to be valid. This is the case even though the stock may be registered in only one of the spouse's names.

Making the election for the initial return will avoid the costs of having to convert a C corporation to an S. Such costs include a LIFO recapture tax on inventory, a built-in-gains tax, a potential penalty tax on excess passive income, and a complicated distribution system to distinguish C corporation earnings from S corporation earnings.

- If the corporation has LIFO inventories, it must pay tax on the amount of its LIFO reserve. The excess of the inventory's value determined using FIFO over that value determined using LIFO is added to the corporate income for the last C corporation year. The resultant tax is paid over four years beginning with the last C corporation year.[32]
- The amount of the corporation's net unrealized built-in gain is subject to a corporate-level tax to the extent that such gains are realized within a 10-year recognition period.[33]
- If the corporation has earnings and profits from C corporation years, distributions become more complicated when the entity becomes an S corporation.[34] The corporation may also be subject to a special tax on excess passive earnings.[35]

The election is made on Form 2553.

Case Study 2-1: The One-Member Entity

Facts

Joe, who is not married, wants to start a restaurant business. Joe will be the only owner of the business. Because of liability concerns, Joe insists on a separate entity that will offer a shield from liability. Joe will not be able to pay all (anticipated) profits as salary because he needs to retain some funds inside the entity for future growth. He wants to avoid two levels of tax on any profits.

Discussion

When there is only one owner, the choice of entity seems to be a relatively simple one. A corporation may be formed with only one owner, and Joe can avoid two levels of tax by making an S election on the entity's first return.

If an S corporation is formed, there may be tax problems with taking assets out of the corporate form because the subchapter C provisions applicable to distributions of property by a corporation also apply to S corporations. Thus, if appreciated property is distributed, a gain will be

[32] Section 1363(d)(2)(B).
[33] Section 1374(d)(7). The reader should note that the Recovery Act of 2009 has shortened this period to seven years for 2009 and 2010 if the seventh year occurs before these years.
[34] Section 1368.
[35] Section 1375.

recognized by the corporation.[36] Although there will be no corporate-level tax imposed, Joe will be required to report the gain as a flow-through item, and the gain may be reported earlier than was intended.

Because there will be only one owner, Joe cannot form a partnership. However, all states permit single owner LLCs, and he should consider an LLC as the ownership form. Regulation §301.7701-3(b)(1)(ii) states that a single member unincorporated entity will be disregarded for tax purposes, unless it elects, under Regulation §301.7701-3(c), to be an association.

Because single member LLCs operating a business will now be taxed as either a sole proprietorship (if the single owner is an individual) or a division (if the single owner is a corporation), taxpayers should consider the LLC as an alternative to an S corporation. The owner may then obtain the benefit of limited liability while avoiding the problems with exiting the S corporate form.

S corporations have historically been a haven for one-owner businesses desiring the liability shield not offered in a sole proprietorship. In fact, more than half of all S corporations have only one owner. Many single owner businesses will still prefer the S form in an attempt to shield income from the self-employment tax. This will be discussed in more detail in the following chapter.

Case Study 2-2: Control Issues with Transfers to Corporations

Facts

Alex, Barb, and Calia propose forming the ABC Corporation. Alex and Barb will each transfer appreciated property and Calia will transfer services. Alex and Barb will receive a total of 76 shares and Calia will receive 24 shares. Because Calia's stock compensation is for services performed in connection with the creation of the corporation and the commencement of its business, the parties agree that there should be no restrictions on Calia's rights to keep the stock (that is, she will not be required to work for the employer for some period after the corporation is formed).

Discussion

The facts, as presented, create tax problems for all three parties to the corporate formation. Because Alex and Barb have transferred appreciated assets, each will have a realized gain when stock is received in exchange for the property. This realized gain must be recognized (pursuant to §1001) unless some other provision in the tax law states otherwise.

Section 351 will allow a transferor of property to avoid gain recognition if the property is transferred to a corporation solely in exchange for stock (the facts do not indicate that any other property was received) if the transferors are in control of the corporation immediately after the exchange. Control is defined in §368(c) to be 80 percent of the voting power and 80 percent of the number of all classes of stock not entitled to vote. Because §351 states the requirement to be "such person or persons are in control," Alex and Barb may aggregate their stock ownership to determine whether the control requirement is satisfied. However, §351(a) clearly states that

[36] See §311(b) for distributions not in liquidation of the entity and §336(a) for distributions in liquidation.

"such person or persons" refers to the parties who have transferred property. Because §351(d)(1) excludes services from the definition of property, Calia is not a transferor and her stock ownership may not be counted in the control test. The result? Alex and Barb must recognize all gain realized from the transfer because they will only have 76 percent of the voting power of the corporation.

All three parties to this proposed transfer have tax problems. Alex and Barb's problems may be cured by using an LLC rather than a corporation or by restructuring the compensation paid to Calia. Calia's problem may be cured by using options rather than a direct transfer of stock, which will also solve Alex and Barb's problem. That is, a corporation may still be a viable entity, but a restructuring should be done. Alternatively, an LLC could be used.

Calia is not a transferor and is not eligible for §351 nonrecognition, whether the parties control the corporation or not. The stock received for services will be subject to §83, which will require Calia to report compensation income equal to the fair market value of the stock received in excess of any amount paid to acquire the stock.

Section 721 provides for nonrecognition of gain when property is transferred to a partnership in exchange for an interest in the partnership. Section 721 has no control requirement. However, §721 also excludes services from the definition of property.

Alex and Barb may avoid recognizing any gain by insisting that the entity to be formed be an LLC rather than a corporation. Because LLCs are taxed under Subchapter K,[37] §721 will apply to the transfers of property. Thus, Alex and Barb may qualify for nonrecognition of gain even if they fail to control the entity.

If the transfers are made to an LLC, Calia will still have to recognize compensation income for the LLC interest that she receives. This is so because she must receive a capital interest to acquire the same economic rights that she would have in the proposed transfer for stock. Section 83 will once again apply to the receipt of a capital interest and Calia will have to pay tax on noncash income.

Calia could avoid this problem by accepting the capital interest subject to a substantial risk of forfeiture, but that risk would jeopardize her economic rights and is not consistent with the intent of the parties. She could also avoid any current income by accepting an interest only in future profits of the LLC, but that "solution" would again jeopardize her economic rights (she may receive nothing at all) and is inconsistent with the intent of the parties.

Before concluding that an LLC is the "right" entity for Alex, Barb, and Calia, we should examine alternatives that would allow the corporate form to be used. There are two ways that we can propose to allow Alex and Barb to avoid recognizing any gain when their property is transferred:

1. Calia may be made a *transferor* if she transfers property in addition to her services. The value of the property must be more than relatively small in relation to the value of stock received.[38] To satisfy the IRS ruling guidelines for this test, the value of the property must be at least 10 percent of the value of the stock received for services.[39] This may be a

[37] Reg. §301.7701 will allow an unincorporated entity formed after 1996 with at least two members to be a partnership by simply filing a Form 1065.

solution, but the facts do not indicate that Calia has any intent to transfer property. Thus, we will treat this "solution" as not feasible.

2. Instead of giving Calia 24 shares of stock immediately upon formation, the shares may be transferred at a later date. Let us assume that the parties wait six months after the corporation is formed before the shares are transferred to Calia. This would present the opportunity to argue that immediately after the transfer to the corporation [the language of §351(a)], Alex and Barb owned 100 percent of the corporation. However, if the later transfer to Calia could be considered to be part of the same plan, it is likely that this strategy would be collapsed and would not be successful.[40] However, Calia could be granted an option to acquire 24 shares of stock, exercisable at Calia's discretion (and perhaps with a ten year expiration). Giving Calia an option to acquire 24 shares, and not the 24 shares directly, can solve the tax problems of all parties because

    a. The control test of §351, which is found in §368(c), does not include attribution of stock ownership. [See the cross reference in §318(b), which does not include any reference to §351. The control test in §351 must be met without attribution because the tax authorities want to make it difficult, and not easy, to meet the control test. Thus, they do not allow attribution to "boost" someone's ownership.] Section 318(a)(4) provides that an option to acquire stock shall be the same as actual ownership, but §318 does not apply to §351 transfers. Thus, if Calia is granted an option to acquire 24 shares, Alex and Barb own 100 percent of actual shares outstanding at the formation of the entity, and both will qualify for §351 protection from gain recognition.

    b. Calia will not report any income until the options are exercised and the stock is acquired. Section 83, and the regulations promulgated thereunder, states that an option is not subject to tax on receipt unless that option has a readily ascertainable fair market value. A nontransferable option in a privately held company will not have a readily ascertainable fair market value. Thus, Calia can avoid the problem of reporting taxable income with no cash, and she can time the exercise to coincide with a year when she wants the compensation income and perhaps with a year when she will sell the stock acquired by exercising the option.

There are at least five other issues to consider in deciding whether a corporation should still be used (with the option idea).

1. If a corporation is to be used to conduct this business, it should probably be an S corporation. An S election will avoid two levels of tax, including a second level of tax on the precontribution gain attributable to Alex and Barb's property.

2. An LLC will require that any precontribution gain attributable to Alex and Barb's property be allocated to the contributing member. Cost recovery deductions attributable to such property must also be allocated so as to take into consideration the difference

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[38] Reg. §1.351-1(a)(1)(ii).
[39] Revenue Procedure 77-37, 1977-2 CB 568, §3.07.
[40] "Immediately after" includes all steps that are part of the same plan. See Reg. §1.351-1(a)(1).

between fair market value and tax basis on the date of contribution.[41] Regulations allow three methods of making such allocations, and the LLC form will add some complexity to future allocations but also create what may be perceived as a more *fair* allocation method than would be the case for an S corporation.[42] The existence of precontribution gain may also create problems when distributions of property are made from an LLC within seven years of the transfer of the appreciated property.[43]

3. If a corporation is selected as the form of entity, and the option strategy is used, the options may not be a second class of stock if an S election is desired. Options granted for employment purposes may not be a second class of stock if the option is nontransferable and does not have a readily ascertainable fair market value.[44]

4. To protect Alex and Barb's §351 treatment, the option may not be the economic equivalent of stock ownership. An option differs from direct ownership of stock for two primary reasons. First, the option allows the holder to acquire a long position in the stock without committing the capital required to purchase the stock. Second, the option protects the holder against any losses for movements in the value of the stock below the option exercise price (because the holder would not exercise the option if the value of the stock dropped below the exercise price). If the option exercise price is set at zero, these two differences do not exist and the option is the same as direct ownership of the stock. [The stock may be acquired by exercise of the option with no economic outlay, eliminating the first difference, and the stock price cannot drop below the zero exercise price, eliminating the second difference.] Thus, the option exercise price must be some positive number to avoid constructive receipt of the stock. If Calia must pay something to acquire the 24 shares, she is not in the same economic position as if she directly received shares. However, if the option has an exercise price less than the fair market value of the stock at the date the option is granted, the overall arrangement may be a deferred compensation arrangement subject to Section 409A.[45] The parties must come to some solution—perhaps providing Calia with a later bonus to exercise options; perhaps giving her more than 24 shares to compensate for the cash outlay (that is, give her the same net economic benefit after considering the additional capital she must contribute when the option is exercised). Alternatively, Calia could be given 18 shares immediately and an option to acquire 6 shares, mitigating the option cost problem. This solution applies to Alex and Barb's control problem, because they will own 76 of 94 shares, or 80.9 percent. However, this strategy might be particularly susceptible to being collapsed under the step-transaction doctrine if the Service could show that there was a pre-arranged plan simply to avoid tax.

5. If Calia receives 24 shares when the corporation is formed, her income will equal the value of the 24 shares measured at the date of formation. If she instead receives an option to acquire stock, her income will equal the excess of the value of the stock when the option is exercised over the amount paid to exercise the option. If the stock value is

[41] Section 704(c).
[42] See Reg. §1.704-3 for the three available methods.
[43] See §§704(c)(1)(B) and 737.
[44] Reg. §1.1361-1(1)(4)(iii)(B).
[45] Prop. Reg. §1.409A-1(b)(5)(i)(A)(1).

increasing, Calia may report more income with the option strategy (although the income would be deferred and may be timed to coincide with a sale of the stock).

Case Study 2-3: Control Problems for Later Transfers

Facts

Kevin and Kelly each own real property that they have held for investment for more than one year. They propose forming a new entity for the purpose of developing the property and selling it for a profit that would include both precontribution gain as well as gain created by the development process. Initially they would each transfer some property that is believed to be currently saleable. In the future, they would each transfer additional property as the entity was able to develop and sell such property. It is expected that they will each own 50 percent of the entity.

Discussion

This case provides an excellent example of why a practitioner needs to carefully consider a variety of tax issues when deciding which form of entity is best suited to the fact pattern.

When Kevin and Kelly first transfer appreciated real property to an entity, they should qualify for non-recognition of gain whether the transfer is made to a corporation, be it a C corporation or an S corporation, or to a partnership, including an LLC. However, if they each own 50 percent of the stock, a later transfer may be taxable if made to a corporation. Because a transfer to a corporation can be nontaxable only if the transferor(s) control the corporation, it would be necessary for Kevin and Kelly to time all property transfers so that they are both transferring property as part of the same transaction. That is, if Kevin transfers property in one year and Kelly transfers property in another year, the two transfers are not likely to be part of the same transaction. As a result, both transfers will be fully taxable. In contrast, the transfers would be tax-free if made to an LLC or partnership because there is no control requirement.

Having made this distinction, we may conclude that Kevin and Kelly should form an LLC with partnership tax treatment so that the future transfers of property to be developed and sold by the entity will be nontaxable. If the goal is a nontaxable transfer to the entity, this would be sound advice. However, it may be possible that the parties would be better served by taxable transfers to the entity, a result that could be more easily obtained if the entity were a corporation (it should be an S corporation to avoid two levels of tax).

In Case Study 1-4 we discussed why a sale of real property to a controlled corporation might be well-advised if the gain from the sale would be capital gain, but the development profit earned by the entity would be ordinary income. Gain from the disposition, whether by sale or by exchange, of real property held for investment should qualify as a capital gain. Once any significant development work is done to the property, any gain from sale is expected to be ordinary income.[46]

Kevin and Kelly may be best served by creating taxable transfers when their property is placed inside the entity. If they agree with this logic, a corporation would be the best entity because the

[46] Case Study 1-4 offers a more extensive discussion of this issue.

control requirement for the application of §351 will allow Kevin and Kelly to qualify postformation transfers in exchange for stock as taxable exchanges, provided they time the transfers so that they are not both transferring property at the same time. Although they could sell the property, it is probably easier to transfer it for stock so that the corporation need not actually purchase the property.

It is important to note that the entity will develop the contributed property and then sell it. If the facts were modified so that the future transfers would be operating assets of a business, an LLC would be the preferred vehicle because the lack of a control requirement would allow those future transfers to be nontaxable. Likewise, if the appreciated assets were to be used in an operating business, it might be better to place these into an LLC and lease the appreciated assets to a corporation.

Case Study 2-4: Contributing Property with Liabilities in Excess of Basis

Facts

Hank and Jennifer intend to form an entity that will offer them protection from liability. Hank will transfer real property with a fair market value of $800,000, together with a liability of $400,000 that the entity will assume. Hank's property has a tax basis of $320,000. Jennifer intends to contribute money and property with a fair market value of $520,000, with a tax basis of $200,000, which will be contributed with $120,000 of liabilities that the entity will assume. Both Hank and Jennifer will receive a 50 percent interest in the new entity.

All liabilities transferred to the entity were incurred when the property in question was acquired. There is a bona fide business purpose for all properties to be transferred to the entity.

Discussion

Because both Hank and Jennifer are transferring property in exchange for an interest in the entity, the general rule of both §351 (applicable to transfers to corporations) and §721 (applicable to partnerships) will protect them from recognizing gain, whether the transfer is to a corporation (be it an S corporation or a C corporation) or a partnership (including an LLC).

Again, as a general rule, the fact that both of the transferors have transferred both property and liabilities that will be assumed by the entity will not affect the statement that no gain will be recognized. However, §357(a) states that assumption of liabilities by a corporation will not be treated as nonqualifying "boot" consideration if the transfer of property otherwise qualifies for nonrecognition treatment. Section 358(d)(1), however, states that for purposes of determining the basis of a shareholder's stock, liability assumption shall be treated as money received by the shareholder. Because §358(a)(1) provides that the basis of a shareholder's stock shall be decreased by the amount of money received in the transfer, a shareholder's stock basis will be reduced by the amount of any liability assumed or taken subject to. This basis adjustment is required to ensure that any realized gain is deferred and not excluded.

Using the basis rules of §358, each shareholder's stock basis will be determined as follows:

	Hank	Jennifer
Basis of Property Contributed	$320,000	$200,000
Less: Liability Transfer	<400,000>	<120,000>
Tentative Basis	<80,000>	80,000

Hank cannot have a negative basis in his stock. To solve this "problem," §357(c) states that a shareholder who contributes property with liabilities in excess of basis will recognize gain equal to the excess of the debt over the basis. Section 358 allows the shareholder to increase the basis of his stock for any gain recognized. Because it is the excess of the liability over the basis that would, absent any other provision, create a negative stock basis, it is that excess that is used as a plug to bring the stock basis to zero, as shown below:

	Hank	Jennifer
Basis of Property Contributed	$320,000	$200,000
Plus: Gain Recognized	80,000	-0-
Less: Liability Transfer	<400,000>	<120,000>
Basis	-0-	80,000

Taxpayers in Hank's situation have attempted to avoid §357(c) gain by contributing a shareholder note for the amount of the excess debt. The argument is that a portion of the stock was purchased for the note, and thereby acquires a cost basis, so that there is no negative stock basis problem. This argument has been accepted by the Second Circuit[47] and the Ninth Circuit[48] based on a strict set of facts.[49]

For transfers after October 18, 1998, §357(d) limits the application of §357 to liabilities "assumed" by the corporation (§357 previously also applied to property transferred "subject to" liability). If an agreement can be reached with the creditor, Hank can avoid any gain recognition by continuing to be liable for the debt so that no assumption had occurred. Alternatively, it is remotely possible he could contribute an $80,000 promissory note and rely on *Lessinger* and *Peracchi* to avoid any gain. The Ninth Circuit was particularly clear that this strategy is not applicable to a flow-through entity and should not be attempted by an S corporation. This strategy should not be attempted without consultation with an attorney.

Section 721 has no statement about the consequences of receiving boot. Instead, the receipt of boot at the time of transfer to a partnership is generally treated in one of two ways:

1. As a distribution by the partnership that occurs immediately after formation. The distribution is subject to §731, which generally treats distributions as nontaxable except where money (which may include certain marketable securities) exceeds the basis of the partner's interest in the partnership.
2. Perhaps as a disguised sale under the provisions of §707(a)(2)(B).

Section 752 states that a partner is deemed to have contributed money to the partnership in the amount of any increase in that partner's share of liabilities of the partnership. Section 752(b)

[47] *Lessinger*, 872 F. 2d 519 (1989).
[48] *Peracchi*, 143 F. 3d 487 (1998).
[49] Taxpayers wishing to attempt this strategy should consult with both their CPA and attorney before engaging in the transaction.

states that a partner is deemed to have received a distribution of money to the extent that that partner's share of partnership liabilities has decreased. Because §731 requires a partner to recognize gain if money is received in excess of basis (which occurs because the basis of the partner's interest must, pursuant to §733, be reduced by the amount of money received), a partner will recognize gain when he or she is relieved of liabilities in excess of the basis of property contributed. However, the amount of such liability relief is a net figure determined by reference to what amount the partner was liable for before a transfer and what amount that partner is liable for after the transfer.

Assume that the risk of loss for the two partnership liabilities ($520,000 total) will be shared equally if the transfer is to a partnership or an LLC. Hank's share has decreased from $400,000 to $260,000; Jennifer's share has increased from $120,000 to $260,000. Hank is deemed to have received a distribution of money equal to the $140,000 reduction; Jennifer is deemed to have contributed money equal to the $140,000 increase. Because the reduction in Hank's share of the liabilities does not exceed the $320,000 basis of his contributed property, he will not be required to recognize any gain.

It may be argued that if the transfer is to an LLC, in which no member has any personal liability under the terms of the operating agreement, the members will not share the risk of loss for liabilities equally. This may well be true, although we would need to significantly complicate the facts to reach any conclusion. Based on the facts of this case, Hank will not recognize gain if the transfer is to a partnership or an LLC. Since the owners want a shield from liability, an LLC would be the appropriate form if it is intended to avoid any gain recognition.

Case Study 2-5: Liability Transfers with Tax Avoidance

Facts

Nicole, who is married, owns real property with a fair market value of $2 million and a tax basis of $1,500,000. Nicole currently has no debt attached to the property. She proposes to transfer the property to a separate entity so that it may be used in a trade or business and so that she has a liability shield. Before the transfer, Nicole proposes to borrow $1 million secured by the property. The property will then be contributed to the entity in exchange for an ownership interest. The entity will assume the new debt.

Discussion

As a general rule, Nicole could transfer this property to any type of entity without recognizing any gain. Section 351 should provide for nonrecognition of gain if the transfer is to a corporation and §721 should provide for nonrecognition of gain if the transfer is to a partnership.

To meet her goal of a liability shield and to avoid two levels of tax (the property is appreciated and there is no reason to create a second level of tax on the built-in gain), she should consider either an S corporation or an LLC.

Section 351 will apply if the transfer is to an S corporation. Section 357(a) generally provides that a corporate assumption of the transferor's liabilities will not be treated as boot for purposes of §351. Thus, §357(a) would allow Nicole to borrow $1 million shortly before the transfer and then transfer the property with an assumption of the liability without any tax concerns. Because

the anticipated liability will not exceed the basis of the property, §357(c) will not be a concern. Nicole will have a potential problem with §357(b), however.

Section 357(b) states that a liability will be treated as boot in a §351 transfer if the facts and circumstances surrounding the acquisition of the liability suggest that a principal purpose of the taxpayer was to avoid federal income tax or if the liability lacks a bona fide business purpose. Regulations §1.351-1(c) raises the stakes for such prohibited transfers of liabilities by treating all liabilities as boot if one liability either has a tax avoidance motive or lacks a bona fide business purpose.

This provision is a serious risk in this situation if the property is transferred to a corporation. If §357(b) applies to the transfer, Nicole must recognize $1 million of gain when the corporation is formed. The existence of a tax avoidance motive, which would trigger the application of §357(b), is less likely to be invoked if the transfer is to an S corporation rather than to a C corporation. This should be the case because distributions from an S corporation, even if used to repay the shareholder debt, could be tax-free to the extent of Nicole's stock basis. However, as this is a general corporate provision, it could apply to either type of corporation, and §357(b) is a concern.

The fact that Nicole proposes to borrow shortly before the liability is transferred to an entity strongly suggests a tax avoidance purpose. What is this purpose? Normally, the mere act of borrowing money is not a taxable event because the taxpayer has to repay the borrowed money, which means that the act of borrowing does not increase the economic worth of the borrower. However, what if one could borrow money and have someone else repay the debt? Then, the logic that suggests that the borrowing is tax-free no longer applies. In this case study, Nicole intends to borrow the money but to have a separate entity repay the debt. Such a strategy may be particularly beneficial if the transfer is made to a C corporation because corporate earnings can be used for the shareholder's benefit (repayment of shareholder-incurred debt) without treating the corporate payment as a distribution. Section 357(b) seeks to prevent this strategy by treating the full amount of the debt as nonqualified consideration when the corporation is formed.

Based on the facts as presented, it is highly likely that the $1 million liability will be treated as boot if the transfer is to a C corporation. The tax avoidance motive would be to have C corporation earnings used to pay a shareholder-incurred (and tax-free) debt without any adverse tax consequences. Section 357(b) would prevent this type of tax avoidance behavior.[50]

If the transfer is to an S corporation, it is not as clear that a tax avoidance motive would be found. Because S corporation distributions are tax-free to the extent of the shareholder's stock basis,[51] the corporation's payment of a shareholder-incurred liability does not offer the same tax avoidance potential. That is, Nicole's stock basis would be $1.5 million *if she did not transfer the*

[50] Please note that Reg. §1.351-3(b)(7) requires a disclosure statement be attached to the corporate return for any year in which a §351 transfer has occurred. This statement requires, among other things, a statement of any liabilities transferred to the corporation including the facts associated with the incurrence of the liability and the business purpose for transfer of the liability to the corporation.

[51] Section 1368(b)(1). This example assumes a new S corporation and not one in which C corporation earnings and profits are present. In such a case an ordering of basis between AAA, OAA and other stock basis occurs with the earnings and profits, which would be taxable as a dividend, occurring between AAA and OAA.

liability to the corporation, but instead retained liability outside the corporation.[52] The corporation could then, perhaps over a term of years, distribute $1 million to Nicole to pay the debt, and such distributions would be tax-free provided her stock basis was not otherwise reduced. Thus, Nicole may be able to defeat a tax avoidance attack if the property and the liability are transferred to an S corporation. However, she must realize that there is a risk that the IRS could contend that §357(b) applies, in which case she would have to recognize $1 million of gain when the corporation is formed.

It would seem that we could solve Nicole's potential problem with §357(b) by suggesting that she instead form an LLC. If Nicole sets up a single-member LLC, no gain will be recognized because the transfer is to a disregarded entity.

Section 721, which allows for a tax-free transfer of property to a partnership, says nothing about the effects of transferring liabilities to the partnership. Section 752 treats increases (decreases) in a partner's share of liabilities as a contribution (distribution) of money to the partner. The disguised sale rule of §707(a)(2)(B) provides that if there is a transfer of property to a partnership, and there is a related direct or indirect transfer of money or property to the partner, and if the two transfers are properly characterized as a sale, then the transfer shall be a sale.

If a partner borrows money shortly before transfer of property to a partnership, and if the partnership assumes the liability, the original borrowing transaction may be viewed as an indirect transfer of money from the partnership (which must repay the debt) to the partner.[53] In this case, the indirect "sale" proceeds are limited to the amount of the liability that is transferred to the other partners under the provisions of §752.[54]

Case Study 2-6: When Money Has Been Borrowed Shortly Before Transfer to an Entity

Facts

Rex owns real property with a fair market value of $2 million and a tax basis of $500,000. Shortly before he intends to transfer the property to an entity, in which he will be a 50 percent owner, Rex borrows $800,000 on a recourse basis and secured by the property. Rex now proposes to transfer the property to an entity that will provide a liability shield. His co-owner will also transfer $1.2 million of property and each owner will have a 50 percent interest in the entity. The entity will assume the liability. If the transfer is to a partnership, each owner will bear a risk of loss for 50 percent of Rex's liability.

[52] If the IRS seeks to show a tax avoidance motive, a defense would be to show what would occur if the liability had not been transferred to the corporation. Nicole's stock basis would be $1.5 million if the liability is held outside of the corporation, and distributions of $1 million to repay the debt could be tax-free. Thus, Nicole is not avoiding any tax by shifting the debt to the corporation (the liability transfer would reduce the basis of her stock to $500,000, but the corporation could then repay the debt without the need to make a distribution to Nicole).
[53] Reg. §1.707-5.
[54] Reg. §1.707-5(a)(2) and (a)(3).

Discussion

If the transfer is made to a corporation, there are two possible results:

1. If the liability that is taken out shortly before the transfer is considered to have a tax avoidance motive, Rex will have $800,000 of boot consideration and he must recognize $800,000 of the $1.5 million realized gain from the transfer. The fact that the liability was incurred shortly before the transfer would tend to indicate that there was a tax avoidance motive for the transfer. If the transfer is to an S corporation, it may be less likely that the transfer will have a tax avoidance motive (see the detailed discussion in Case Study 2-5 for an explanation). However, because the basis of the stock will be only $500,000, there may be a tax avoidance motive (avoiding a corporate distribution, which will eventually be in excess of basis, to repay the debt) even in an S corporation.

2. If there is no tax avoidance motive, §357(c) still applies and will require that Rex recognize $300,000 of gain ($800,000 liability transferred to the corporation in excess of $500,000 basis of contributed assets) from the transfer. See Case Study 2-4 for a detailed discussion of the §357(c) problem.

If the transfer is made to a partnership, which should be an LLC to provide a liability shield for Rex, there are again two possible results:

1. If §721 applies, together with a deemed cash distribution under §752 to the extent that Rex's share of the liability is reduced by $400,000, Rex will recognize no gain because the reduction in his share of the liability does not exceed the basis of the property transferred. That is, he will begin with a basis in his interest of $500,000 pursuant to §722. The reduction in his share of the liability will be a deemed distribution of $400,000, which will, under §733, reduce the basis of his interest to $100,000. Because the deemed distribution does not exceed the basis of his interest, he will not recognize any gain.

2. If the transaction is treated as a disguised sale under 707(a)(2)(B), Rex must recognize gain as if he sold a portion of his property. A disguised sale requires a transfer of property to a partnership together with a related transfer from the partnership to the partner. Because Rex's liability was incurred shortly before the transfer to the partnership, it is very likely that he will have disguised sale proceeds measured by the amount of the liability shifted to the other LLC member. The basis of Rex's contributed asset must be allocated between the disguised sale and the contribution. Because Rex has shifted one-half of the liability to the other member, he will be deemed to have sold the property for $400,000 (one-half of the liability). This amount represents one-fifth of the value of Rex's property. Rex will then be treated as if he had sold one-fifth of his property, with the remaining four-fifths contributed in exchange for an interest. The $500,000 basis must be allocated among the sale and the contribution based on the ratio that the sale proceeds bear to the fair market value of the property. One-fifth of the basis, or $100,000, is allocated to the sale. The gain from the sale is then $300,000, the excess of the deemed sale proceeds ($400,000 debt transferred to the other member) over the $100,000 allocated basis.

So in summary, a transfer to an LLC may or may not result in gain recognition by Rex. Based on these facts, however, it is likely that the transaction will be a disguised sale and that Rex will recognize gain of $300,000.

When a liability is incurred for a tax avoidance motive, that is, shortly before transfer to an entity with more than one owner, a gain will probably result whether the transfer is made to a corporation or to a partnership. The amount may differ, although it may not be a significant enough difference to affect the choice of entity.

An LLC may still be the best entity choice because it will offer Rex and his co-owner more flexibility with respect to postformation tax considerations, although §704(c) allocations with respect to the built-in appreciation of the assets will also be required. It may also be possible to structure the partnership (LLC) arrangement so that Rex's share of the recourse liability is not reduced by the transfer, thereby avoiding a disguised sale. For this second alternative, an attorney well-grounded in both liability and partnership state law issues should be consulted.

Chapter 3
Operations

Salary and Self-Employment Tax Issues

The different forms of entity may create different payroll tax liabilities for the various members. It may be possible to eliminate the corporate tax in a C corporation by paying all profits as compensation, as long as such compensation is reasonable.[55] However, such payments will be subject to payroll taxes, which are presently 15.3 percent until the OASDI wage base is reached, but which may increase in future years.[56]

The substantial increases in payroll taxes have led to a strategy of undercompensating employee-owners of S corporations.[57] Because shareholders may also be employees for compensation purposes, no payroll taxes are imposed on any payments to owners that are properly considered distributions and not properly classified as compensation. Of course, the IRS may contest what the owners classify as compensation, and the IRS has been successful in such attacks when no compensation has been paid.[58]

Because partners are not employees of the partnership, neither the partners nor the partnership will be responsible for payroll taxes on any portion of a partner's income from the partnership. However, partners may be subject to self-employment tax liability for all or a portion of their share of partnership income. The partners would be responsible for completing Schedule SE and computing their self-employment tax liability. However, the Schedule K-1 provided to each partner would report his or her share of self-employment income from the partnership.

Section 1402(a) defines net earnings from self-employment to include an individual partner's distributive share of any income from a trade or business conducted by the partnership. Partners are also subject to self-employment tax on guaranteed payments for services. For this purpose, a trade or business is defined in the same manner as for purposes of §162, which relates to ordinary and necessary expenses of a trade or business. Section 1402(a) then lists a variety of exclusions from the definition of net earnings from self-employment.

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[55] Some businesses will also desire to reward service providers with a chance to participate in the ownership of the entity through a profits interest in a partnership or through stock options or appreciation rights in the case of a corporation. This is not included in the present discussion of self-employment tax issues, but is presented in Case 3-5 at the end of this chapter.

[56] The health care changes increase the Medicare tax on salary and self-employment earnings in excess of $200,000 ($250,000 MFJ) by 0.9 percent on the employee half beginning in 2013.

[57] A legislative proposal to subject the ordinary income share of an S corporation shareholder's interest to employment taxes was not enacted into law in 2010. The GAO has proposed this as a potential solution to the shareholder compensation issue. An alternative GAO proposal is to subject distributions to employment tax.

[58] See *Spicer Accounting, Inc.*, 918 F.2d 90 (9th Cir. 1990); *Joseph Radtke*, 712 F. Supp143 (E.D. Wis., 1989); *Dunn and Clark* (DC Idaho, 1994); *Joseph M. Grey*, P.C., 119 T.C. No. 5; *Veterinary Surgical Consultants, P.C.*, 117 T.C. 141, 145 (2001); and *Yeagle Drywall Company, Inc.*, T.C. Memo. 2001-284.

General Partners are subject to self-employment tax for their share of partnership income earned from the conduct of a trade or business. If the partnership is engaged in a trade or business, so too is each general partner of that partnership. However, income items not attributable to the trade or business, such as certain rent income, dividend and interest income not connected with the business, and capital gains and losses, are not part of the general partner's earnings from self-employment.

A general partner who is an individual is subject to self-employment tax on his distributive share of partnership income that is earned from the conduct of a trade or business by the partnership. It is often incorrectly stated that a general partner is subject to self-employment tax on *all* of his distributive share of partnership income. It is necessary to exclude certain sources of income that do not arise from a trade or business, as is permitted by the exclusions of §1402(a).

Because limited partners are not able to participate in the management of the partnership without loss of their status as a limited partner, a limited partner is not generally regarded as being in the trade or business of the partnership. Thus, a limited partner's share of partnership income is not subject to self-employment tax. There are two exceptions to this rule:

1. If the limited partner receives a guaranteed payment [as defined in §707(c)] for services, the guaranteed payment is subject to self-employment tax.[59]
2. If a limited partner participates in the management of the partnership, so that the status as a limited partner is lost, the rules applicable to a general partner will apply. That is, because the limited partner has become a general partner by prohibited participation in management, he is engaged in the trade or business of the partnership in the same manner as a general partner.

A member of a limited liability company is somewhat of a hybrid of a general and a limited partner. The member enjoys the liability shield similar to that of a limited partner, but also has the ability to participate in management like a general partner. Before any guidance was issued, many practitioners optimistically believed that LLC members would be subject to the limited partner rules for self-employment tax purposes. Proposed regulations issued under §1402 are not so generous.[60]

The proposed regulations attempt to distinguish an LLC member who is more like a general partner from one who is more like a limited partner.

Note. The proposed regulations are *not* authoritative. Congress established a moratorium on the issuance of any guidance on the SE treatment of members of an LLC. Until legislation is issued, many practitioners follow the proposed regulations.

Whether LLC members are more similar to limited partners or to general partners depends on their involvement in the LLC. The proposed rules for self-employment tax treatment of LLC members attempt to discern whether a particular member is more like a general partner or a limited partner.

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[59] Section 1402(a)(13).
[60] Prop. Reg. §1.1402(a)-2.

Under the proposal, the general rule is that every member of an LLC is a limited partner.[61] Three exceptions treat a member as a general partner if the member (1) has personal liability for claims against the LLC by reason of being a member of the LLC (in other words, not by some side agreement such as a personal guarantee of a debt); (2) has authority under local law to contract on behalf of the entity; or (3) participates in the entity's trade or business for more than 500 hours during the year.[62] Satisfying any one of these exceptions will generally make the member a general partner for SE tax purposes. Also, if the LLC is a service entity (one in which substantially all of the activities involve performing services in certain professional fields), any member who provides more than a *de minimis* amount of services is automatically a general partner.[63]

A member of an LLC who is a general partner solely because of more than 500 hours of participation may be treated as a limited partner if the entity has only one class of interest, if limited partners (as defined above) own a substantial and continuing interest in that class (20 percent is clearly substantial), and if the member's interest is identical to the limited partners' interests. This exception does not apply if authority to contract is the reason for a member's classification as a general partner.[64]

If the LLC has more than one class of interest, a member classified as a general partner because of either authority to contract or participation for more than 500 hours, may be treated as a limited partner for any class of interest for which limited partners (as defined above) own a substantial and continuing interest (20 percent is clearly substantial) and for which the member's interest is identical to the limited partners' interests.[65] This rule is intended to parallel the existing rule that allows a partner to hold both general and limited partnership interests, with SE liability applying separately to each such interest.

An alternative to the proposed regulations has been suggested by the AICPA and the ABA. A partner, including a member of an LLC, will not be subject to SE tax on any reasonable return to capital invested in the entity. This alternative suggests establishing new §1402 legislation that will include safe harbors. A version of this strategy is to require the LLC member to receive a guaranteed payment for the value of services provided, which would be subject to SE tax and then not subject the ordinary income share to SE tax. This strategy puts the LLC member into an equivalent position with an S corporation shareholder in terms of SE tax parity. However, the author cautions that while this seems a fair alternative on its face, there is no statutory or regulatory guidance that supports this alternative.

Based on the primary authority available, the determination of the member's SE tax liability would appear to be determined based on whether the LLC has defaulted to partnership taxation or elected S corporation taxation. If partnership taxation is applicable, then it must be determined whether the partner is more like a general partner or a limited partner in terms of the member's activities in relation to the entity.[66] Needless to say, this is a contentious area among even the most experienced practitioners. It is important that the CPA discuss the ambiguity of this area

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[61] Prop. Reg. §1.1402(a)-2(h)(1).
[62] Prop. Reg. §1.1402(a)-2(h)(2).
[63] Prop. Reg. §1.1402(a)-2(h)(5).
[64] Prop. Reg. §1.1402(a)-2(h)(4).
[65] Prop. Reg. §1.1402(a)-2(h)(3).
[66] It should be noted that the partnership K-1 requires disclosure of whether a member is a managing member.

with his or her clients and that there be a clear understanding of the reasoning for the SE treatment that is chosen.

Losses and Use of Debt Basis

Flow-through entities will pass losses generated by the entity's activities to the entity owners. This is not the case for C corporations. The losses generated by a C corporation will be eligible for a carryback or carryforward under the net operating loss rules applicable to corporations. Should the corporation have no profits in earlier years, the carryforward to future years would be the only option.[67]

Since many businesses experience losses in the early years of operations, owners who have other types of income from other sources may experience a tax benefit by having losses pass through from the new entity. Since it is generally tax friendly to move from a flow-through form to a C corporation form, owners may choose to structure the entity initially as a pass-through in order to take advantage of these early losses and then shift to the corporate form after the entity becomes profitable.[68] Such pass-through losses are, however, subject to three levels of limitations: basis, at-risk, and passive.[69]

Partner's Basis

The general rule of §705(a) provides that the adjusted basis of a partner's interest (outside basis) in a partnership is the basis in the contributed property and the increased partner's distributive share of

- Taxable income of the partnership,
- Income of the partnership exempt from tax, and
- The excess of the deductions for depletion over the basis of the property subject to depletion;

and decreased (but not below zero) by distributions and by the sum of his or her distributive share for the tax year and prior tax years of

- Losses of the partnership,
- Expenditures of the partnership which are not deductible and not properly chargeable to capital, and

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[67] The business is allowed to elect to forego an NOL carryback even in cases in which it does have taxable income in potential carryback years.

[68] As noted throughout this course, there are a number of other factors that will impact this decision including liability concerns and relative tax rates. For example, liability issues may dictate the need for a corporate form initially in spite of the inability to pass through losses. Where all other issues are equivalent, however, setting up as a flow-through allows for the pass through of income with a tax-free or tax-preferred option to move into a C corporation form, while the alternative option (C corporation to flow-through) would not have this preference.

[69] It should be noted that the hobby loss rules of §183 also apply to partnerships and S corporations, as well as individuals, estates and trusts. This course assumes that the entity is going to be engaged in a trade or business with the goal of generating a profit, so these rules are not discussed herein.

- Decreased (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property where it does not exceed the proportionate share of the adjusted basis of such property allocated to such partner.

Section 752 provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, is treated as a contribution of money by such partner to the partnership. Likewise, any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, is treated as a distribution of money to the partner by the partnership.

Section 704 limits the deduction for losses to the amount of outside basis. These losses will carry over and can be used in future years. The carryover must be allocated if it is composed of more than one type of loss. Losses suspended due to lack of basis are not taken in the year of disposition as is the case for passive losses.

In the partnership setting, basis includes the partner's share of liabilities. Recourse liabilities are allocated among the general partners based on economic risk of loss, which involves a hypothetical liquidation scenario. Generally a partner bears risk of loss to the extent that the partner would be obligated to pay the debt if all partnership assets were worthless and all liabilities due and payable. For this purpose, economic arrangements are taken into account. Also, the pledging of personal property is a risk of loss. A nonrecourse loan if made from the partner to the partnership is considered recourse with respect to that partner.

Nonrecourse liabilities are allocated across all partners using a three-step system. A partner's share of nonrecourse liabilities consists of (1) the partner's share of minimum gain determined in accordance with §704(b) regulations; (2) if the debt is secured by contributed property, the amount of gain the partner would recognize under §704(c) if the partnership disposed of property in a taxable transaction for exactly the amount of the liabilities; and (3) the partner's share of any remaining nonrecourse liabilities based on profit sharing ratios.

S Shareholder's Basis

Section 1367 provides that the shareholder's basis in stock is increased for the shareholder's portion of

- Separately stated items of income,
- Any nonseparately computed income, and
- The excess of the deductions for depletion over the basis of the property subject to depletion.

Basis in the stock is decreased (but not below zero) by

- Distributions by the corporation which were not included in the shareholder's income,
- Separately stated items of loss and deduction,
- Any nonseparately computed loss,

- Any expense of the corporation not deductible and not properly chargeable to capital, and
- The amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to the shareholder.

Unlike the partnership setting, the shareholder does not receive basis in debt of the corporation. In order for the shareholder to obtain basis through debt, it must be debt due directly to the shareholder. The rules of §1367 provide that debt basis is reduced only after stock basis has been reduced to zero. Likewise, the basis in debt will be restored before the basis in stock.[70]

At-Risk Rules

Section 465 provides for the at-risk rules. They affect partners and S shareholders and sole proprietors at the owner level.[71] The provision limits losses to the amount the partner or shareholder has "at-risk" in the venture. The owner is at risk for money and the adjusted basis of property contributed and amounts borrowed if personally liable or if secured by property of the taxpayer up to the value of the securing property.

Section 465(b)(3) provides that borrowed amounts are not considered to be at risk with respect to an activity if borrowed from any person who has an interest in the activity or from a related person to a person (other than the taxpayer) having such an interest. This rule does not apply to interests as a creditor in the activity nor does it apply to an interest as a shareholder in the case of amounts borrowed by a corporation from the shareholder.

Most nonrecourse financing will not be considered as at risk. However, qualified real-estate financing will be at risk. Qualified nonrecourse financing is

- Borrowed by the taxpayer with respect to the activity of holding real property,
- Borrowed by the taxpayer from a qualified person or represents a loan from any federal, state, or local government or instrumentality thereof, or is guaranteed by any federal, state, or local government,
- Except to the extent provided in regulations, with respect to which no person is personally liable for repayment, and
- Not convertible debt.

To meet this exception, the loan must be lent by a qualified party. Such a qualified party is defined by cross reference to §49(a)(1)(D)(iv) as any person actively and regularly engaged in the business of lending money and not

[70] Regulations issued in late 2008 limit the amount of debt treated as open account debt to $25,000 for advances after the effective date of the regulations. The shareholder may still lend more than this amount to the S corporation as an open advance, but such amounts are treated as if the debt were in writing. Further detail on the distinction between open account and written debt are beyond the scope of this course.
[71] The at-risk rules also apply to closely held corporations in which five or fewer shareholders own more than 50 percent of the stock at any point during the second half of the tax year.

- A related person with respect to the taxpayer,
- A person from which the taxpayer acquired the property (or a related person to such person), or
- A person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).

It is possible for some related parties to still be qualified for this purpose, however. The first of the three preceding bullets can be disregarded if the financing from the related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons.

Section 465(c) provides that §465 applies to any taxpayer engaged in the activity of

- Holding, producing, or distributing motion picture films or video tapes,
- Farming [as defined in §464(e)],
- Leasing any §1245 property [as defined in §1245(a)(3)],
- Exploring for, or exploiting, oil and gas resources, or
- Exploring for, or exploiting, geothermal deposits [as defined in §613(e)(2)]

as a trade or business or for the production of income. Generally the taxpayer's activity with respect to each of the items is considered a separate activity. There are some aggregations allowed, however. For example, in a partnership or S corporation, all the activities with respect to §1245 properties leased or held for lease and placed in service in any tax year are treated as a single activity.

Passive Loss Rules

Section 469 provides the passive loss rules. This section imposes a rule in which the losses from passive activities are allowed only to the extent of passive income. This provision again affects partners and S shareholders at the owner level.[72] Losses that are disallowed under the passive rules are carried forward.

Under these rules, rental activities are considered passive. There is an exception for active participation for up to $25,000 in losses if the taxpayer meets certain tests and AGI limits. There is also an exception for real estate professionals.

To qualify for this real estate exception, more than one-half of the personal services performed in trades or businesses by the taxpayer during the tax year must be performed in real property trades or businesses in which the taxpayer materially participates, and the taxpayer must perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. For this purpose, a real property trade is defined as any real

[72] The passive loss rules are also applicable to closely held corporations and personal service corporations. In the case of closely held corporations (not PSCs), net passive losses may offset active income, but not portfolio income.

property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Portfolio income is distinguished from passive income for this purpose. Limited partners are generally considered passive unless they can meet three of the seven tests below. It should be noted that this level of participation by a limited partner could jeopardize the partner's limited partner status (he or she might be considered a general partner based on that level of participation). A limited partner considering more participation in order to overcome the rules should consult with legal counsel to ensure that limited liability protection will be maintained.

In general, the activity is considered to be passive if the owner does not materially participate. Material participation is defined in Temporary Regulation 1.469-5T as one in which:

- The individual participates in the activity for more than 500 hours during such year;
- The individual participation in the activity for the tax year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
- The individual participates in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;
- The activity is a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
- The individual materially participated in the activity for any five tax years (whether or not consecutive) during the ten tax years that immediately precede the tax year;
- The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
- Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Allocations in Flow-Through Entities

Overview

In this chapter, we will discuss the manner of allocating profit and loss of a flow-through entity to the owners of that entity. Because a C corporation is itself subject to tax on corporate income, there is no allocation of C corporation income to the shareholders. Thus, the material in this chapter is limited to S corporations, partnerships (limited partnerships, general partnerships, and LLPs), and LLCs.

S corporation allocations must be in proportion to ownership of stock. A partnership may use special allocations which may be disproportionate to ownership interests if the partners (or

members) so agree and the agreement is structured to satisfy the substantial economic effect test of the tax law. (However, allocations of nonrecourse deductions cannot meet the substantial economic effect test but may be allocated disproportionately to ownership if another test is met.)

Allocations of S corporation items of income, deduction, gain, and loss must be made on a per-share, per-day basis.[73] That is, the allocations must be in proportion to ownership of stock. In contrast, partnerships may allocate tax items by agreement, provided the agreement has *substantial economic effect*. This requirement, to be discussed in detail in this chapter, essentially requires an allocation to have an effect regarding the dollar amount that a partner will receive and not just a tax effect. Partnership allocations that are not proportional to ownership interests are called special allocations.

Certain allocations of partnership items cannot satisfy the substantial economic effect test because the items in question relate to nonrecourse borrowings. These allocations are called nonrecourse allocations and the partners may share such items disproportionately to ownership interests if another test is satisfied.

The ability to allocate items of income, deduction, gain, and loss among the owners by agreement, even if that agreement results in allocations disproportionate to ownership interests, is often cited as one of the key advantages that partnerships and LLCs have over S corporations. However, the substantial economic effect test will increase the costs of establishing and maintaining the partnership.

Legal and accounting fees will be higher for a partnership with special allocations because the partnership agreement will be more complex and the partnership must comply with certain requirements throughout the life of the entity. Nonetheless, it is better to have the choice of making such allocations, and the partners may weigh the benefits of allocations that are disproportionate to ownership interests against the costs of satisfying the tax law requirements.

Assume that Joe transfers property valued at $100,000 and with a tax basis of $50,000 to a flow-through entity in exchange for a 50 percent interest. If the property is later sold for $100,000, how the owners share the $50,000 gain depends on which form of entity was selected. If the entity is an S corporation, only 50 percent of the gain is allocated to Joe; if the entity is a partnership or an LLC, all of the gain is allocated to Joe.

When partners or members of an LLC contribute property that has a fair market value different from its tax basis, future allocations with respect to that property must be made in a special manner. Such allocations are called §704(c) allocations and may be good or bad for the partners, depending on facts and circumstances.

On the one hand, §704(c) allocations ensure that one partner will not have to report gain or loss that was realized when another partner owned the property. The partner who did not contribute the property will probably be pleased with this result. On the other hand, the partnership's reporting will be complicated by the need to make the §704(c) allocations. Many partnerships would prefer to avoid this complexity (and added compliance cost) regardless of how the individual partners may be affected.

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[73] Section 1377(a).

Subchapter S has no equivalent to §704(c). All items of income, gain, deduction, and loss must be allocated in proportion to stock ownership regardless of whether any portion of such gain or loss properly relates to the time before the property was acquired by the corporation. This may be unfavorable if one or more shareholders do not like an allocation of gain or loss that belongs to another shareholder. It may be favorable if the corporation and the shareholders believe the tax costs are less than the added compliance costs of §704(c). Of course, once the S corporation form is selected, the shareholders and the corporation have no choice with respect to §704(c)-type allocations. However, how the parties want to account for precontribution gains and losses may affect which type of entity they select.

S Corporation Allocations

GENERAL RULE

Section 1366(a)(1) states that, in determining his tax liability, each shareholder of an S corporation shall include his *pro rata* share of all ordinary income or loss and all separately stated items of S corporation income or loss. Section 1377(a)(1) defines the shareholder's *pro rata* share as being determined by assigning income to each day of the year and then dividing the portion assigned to each day by the shares outstanding on that day. Thus, all items are shared on a per-share (proportionate to ownership), per-day (proportionate to the number of days on which stock was held) basis.

EXCEPTION—TERMINATION OF A SHAREHOLDER'S INTEREST

Section 1377(a)(2) allows an S corporation to close the books when a shareholder has completely terminated his interest in the corporation. If the books are closed on the date of termination, tax items are still allocated on a per-share, per-day basis, but the allocation is made as if the corporate year consists of two years.

Example 3-1

Jackson Corporation, an electing S corporation, reports $100,000 of income for the tax year. Joe Jackson owned 10 percent of the stock until he sold all of his interest to Sam Shoeless. The sale occurred exactly one-fifth of the way through the year. Under the general rule, $10,000 of income will be allocated to the 10 percent interest for the tax year. Because Joe held the stock for one-fifth of the year, he will report $2,000 of that income and Sam will report the other $8,000. If the exception applies and the books are closed on the date of sale, the corporation will need to determine the income or loss for the first one-fifth of the year. If that income is $15,000, Joe's share of income for the termination year is $1,500 (10 percent of $15,000). Sam's share of income is $8,500 (10 percent of the income earned in the second tax year). No shareholders other than Sam or Joe will be affected by the method of allocation selected.

The closing of the books is available only if the following two conditions are satisfied:[74]

1. A shareholder's interest has been completely terminated during the S corporation's tax year; and
2. An election is made to close the books.

In addition, a qualifying disposition described in Reg. §1.1368-1(g)(2) will also allow the corporation to elect to use the exact method of accounting. A qualifying disposition is

1. A transaction in which a single shareholder disposes of at least 20 percent of the outstanding stock of the corporation during a 30-day period,
2. A redemption under §302(a) or §303 of at least 20 percent of the corporation's stock from a single shareholder, or
3. A transaction in which the corporation issues stock equal to at least 25 percent of the previously outstanding stock of the corporation to one or more new shareholders during a 30-day period.

For tax years beginning before January 1, 1997, the election to close the books had to be made by the S corporation and all of its shareholders, including those shareholders who were not directly affected by the election. [Other than the shareholder who terminated his interest and the shareholder(s) who acquired that interest, no other shareholder's share of the corporate income or loss would have been affected by the election.]

For tax years beginning after December 31, 1996, the election to close the books is made by the S corporation and the shareholders who are affected by the election. That is, the post-1996 election is made only by the shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year.

TERMINATION OF S ELECTION

The above discussion relates to an S corporation that qualifies throughout the year. If the S election is terminated during the tax year, a short period return is filed as an S corporation and a short period return is filed as a C corporation. The S year ends the day before the termination is effective.[75]

Generally, §1362(e)(2) requires that all items be allocated *pro rata* between the two years. The S shareholders then share items attributable to the S year on a per-share, per-day basis. Section 1362(e)(3) allows an election to close the books with items allocated between the S year and the C year using normal tax accounting principles. This election must be made by all shareholders in the S year and all shareholders as of the first day of the C year.[76] Note, however, that the books

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[74] Section 1377(b).
[75] Section 1362(e)(1).
[76] The election to close the books is also available when a shareholder in an S corporation terminates his entire interest. For years beginning after 1996, §1377(a)(2) allows such an election to be made by consent of the terminated shareholder and the party to whom shares were transferred by the terminated shareholder. That is, there is no need to obtain the consent of shareholders not affected by the election to close the books. However,

must be closed in an S termination year with respect to any item resulting from §338 or if there is a sale or exchange of 50 percent or more of the stock in such corporation during such year.[77]

Partnership and LLC Allocations

GENERAL RULE

Section 704(a) states the general rule that distributive share items of a partnership shall be allocated in accordance with the partnership agreement. However, there are several situations in which the CPA will not be able to rely upon the partnership agreement when determining a partner's distributive share. These situations are described in the following Sections.

EXCEPTION—NO PARTNERSHIP AGREEMENT

If there is no agreement as to how distributive shares will be determined, the allocations must follow each partner's interest in the partnership.[78] In theory, a partner's interest is similar to an S corporation shareholder's stock ownership. In practice, each partner's interest is determined using all facts and circumstances, and it may be quite difficult to determine partners' interests.

EXCEPTION—TAX LAW MAY NOT RESPECT THE PARTNERSHIP AGREEMENT

Even if the partnership agreement specifically provides for the determination of each partner's distributive share, there are several situations in which the agreement will not control the determination of the partners' distributive shares. We will examine the following four situations in which the tax law may override a partnership agreement.

1. If the partnership agreement determines distributive shares other than by use of the partners' interests in the partnership, the agreement will be respected only if the allocations have substantial economic effect.[79] An allocation that does not follow the partners' interests is called a special allocation.

2. Distributive share items attributable to property contributed to the partnership with a value that differs from its tax basis must be allocated among the partners to take account of the difference between value and tax basis. Partnerships that make special allocations must be aware that the 704(c) rules will, if applicable, override special allocations even if the substantial economic effect test is met.

3. When ownership interests change during a tax year, Section 706(d) requires that allocations during the year take into consideration the varying ownership interests. The partnership may be forced on the accrual method for certain *allocable cash basis items*.

4. The so-called *family partnership* rules of §704(e) may restrict the distributive share of a donee partner. If a partnership interest is acquired by gift, the donee's distributive share may not be proportionately greater than the donor's distributive share, with each partner's

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§1362(e)(3)(B) requires that when the S election is terminated, the election to close the books must be made by all S shareholders and all C corporation shareholders because they will all be affected by the election.

[77] Section 1362(e)(2).

[78] Section 704(b)(1).

[79] Section 704(b)(2).

share measured in relation to capital. Also, the donee's distributive share must be determined after reasonable compensation has been paid to the donor for any services provided to the partnership. Any interest acquired from a spouse, ancestors, lineal descendants, or trusts for the primary benefit of such persons will be deemed to be acquired by gift for this purpose, even if fair consideration is paid.

WHEN THE TAX LAW RESPECTS SPECIAL ALLOCATIONS—SECTION 704(B)

A special allocation refers to one which is not in accordance with the partner's interest in the partnership. Thus, a special allocation is one which does not follow the general allocation rule.

Example 3-2

Lynn and Jackie form the JL partnership, each contributing $100,000. If the interests of both Lynn and Jackie are 50 percent, then an allocation of all items of partnership income and loss 50 percent to Lynn and 50 percent to Jackie would be a general allocation. Any other allocation would be a special allocation.

Since these optional allocations provide the opportunity to shift tax consequences among the partners, there are detailed rules intended to deny the validity of an allocation that is inconsistent with economic reality. Stated simply, the tax and economic consequences of the allocation must match. Practically, the mechanics of the substantial economic effect test must be met if the allocation is one of recourse deductions. If the allocation is of nonrecourse deductions, it may be deemed to be in accordance with the partner's interest if certain requirements are satisfied.

The requirement that a special allocation has substantial economic effect is intended to ensure that the partner to whom loss or deduction is allocated is the one who bears the economic burden associated with that item. Similarly, the partner who has income allocated to him or her should be the one who receives the economic benefit associated with that income.

Practically, it may be quite difficult to match income and loss with the party receiving the benefit or burden associated with that item. This is particularly true when items of tax income or deduction are not associated with an immediate and recognizable economic benefit or burden. For example, cost recovery deductions are not often matched with an equivalent decline in the value of a depreciable asset.

The §704(b) regulations deal with the difficulty in measuring and tracing economic benefits and burdens by use of several fairly objective tests and through use of safe harbors for the more subjective parts of the substantial economic effect test. The regulations must make some concessions to administrative convenience. Thus, with appropriate deference to the regulations, substantial economic effect is defined to exist when the partnership agreement satisfies certain tests, even if the practitioner may identify circumstances in which the link between the tax allocation and the economic effect seems to be tenuous.

TWO-PART TEST TO SATISFY THE SUBSTANTIAL ECONOMIC EFFECT TEST

To satisfy the substantial economic effect test, an allocation must satisfy two separate tests. First, the allocation must have economic effect. Then, the economic effect must be substantial.

ECONOMIC EFFECT

Generally, economic effect will exist if the partnership agreement contains three provisions:[80]

1. Partnership capital accounts are maintained in accordance with specific rules contained in the §704(b) regulations.
2. Throughout the term of the partnership, distributions from the partnership in liquidation of a partner's interest must occur in accordance with positive capital account balances.
3. A partner who has a negative balance in his or her capital account, determined as of the date of liquidation of his or her interest, must contribute assets to the partnership to eliminate the deficit.

The third requirement, that a partner with a deficit capital account balance restore such deficit, is the most troublesome to limited partners and members of limited liability companies. However, as long as an allocation does not create a deficit capital account balance which a partner has no obligation to restore, and provided one other provision is included in the partnership agreement, the third requirement may be waived.

To waive the third requirement, the partnership must satisfy the *alternate test for economic effect*, which requires that the first two parts of the three requirements are part of the partnership agreement, and that the agreement contain a qualified income offset. Basically, a *qualified income offset* acts to ensure that a partner will not have a deficit capital account balance for which he has no obligation to restore.

SUBSTANTIALITY

In addition to satisfying the economic effect test, the economic effect of an allocation must be substantial. This means that the allocation must substantially affect the dollar amounts to be received by the partners, independent of tax consequences.[81]

It is not clear how the IRS would interpret the term *substantially* in this context. Treasury regulations do, however, describe three situations in which the economic effect of an allocation will not be substantial.

One requires a present value analysis of economic benefits and burdens resulting from an allocation. The others deal with abusive allocations which are designed to shift tax consequences either within one time period (shifting allocations) or across multiple time periods (transitory allocations).

CONSEQUENCE OF FAILING THE SUBSTANTIAL ECONOMIC EFFECT TEST

If either the economic effect or the substantiality test fails, the tax items must be reallocated in accordance with the partners' interests in the partnership. As mentioned earlier, measuring a partner's interest may be a difficult task.

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[80] Reg. §1.704-1(b)(2)(ii)(a).
[81] Reg. §1.704-1(b)(2)(iii)(a).

NONRECOURSE DEDUCTIONS: ALLOCATIONS "DEEMED" IN ACCORDANCE WITH PARTNERS' INTERESTS

The preceding discussion, dealing with the substantial economic effect test, applies only to recourse allocations. Stated generally, recourse allocations refer to those allocations that are not financed by nonrecourse borrowings of the partnership. Any deductions financed by nonrecourse borrowings are nonrecourse deductions. Because no partner bears the risk of loss associated with nonrecourse borrowings, the link between allocating a deduction to the partner who suffers the detriment associated with the deduction is severed and there can be no economic effect associated with nonrecourse deductions.

Because of the lack of economic effect for such allocations, the regulations allow significant flexibility in allocations of nonrecourse deductions. That is, it is somewhat arbitrary as to who receives an allocation of deductions for which no partner will suffer an economic detriment. Thus, the regulations adopt the practical approach of allowing flexibility.

NONRECOURSE DEDUCTIONS DEFINED

A nonrecourse deduction arises only in a year in which the partnership's *minimum gain* increases. Minimum gain is defined as the excess of partnership nonrecourse liabilities over the book value of the property securing the nonrecourse debt. Under §1001, the relief of liabilities as part of a sale or exchange transaction is treated as sale proceeds. Thus, if the partnership simply allows nonrecourse creditors to take property in exchange for the partnership's debt obligation, the balance of the nonrecourse debt would be the minimum *sale* proceeds. If the balance of the nonrecourse debt exceeds the basis of property securing that debt, that excess will be the minimum amount of gain recognized from a sale or exchange.

Example 3-3

The XYZ partnership owns a building with a basis of $800,000 and that is subject to a $1.2 million nonrecourse debt. Even if the property is valued at only $500,000, XYZ will recognize a gain of $400,000 if it walked away from the property and allowed the creditor to take the property in satisfaction of the nonrecourse debt. Thus, the minimum gain is $400,000. If the partnership depreciates the property at the rate of $50,000 each year, and the principal balance of the nonrecourse note remains unchanged (that is, if it is interest-only), the minimum gain will increase by $50,000 each year. Then, the $50,000 depreciation deduction would be classified as a nonrecourse deduction.

Partnership minimum gain may arise in several circumstances. If the partnership purchases property with nonrecourse financing, cost recovery deductions will typically reduce the basis of the property at a rate faster than the principal reduction of the note. After the passage of some time, the partnership may find that the amount of the debt exceeds the adjusted basis of the property, creating nonrecourse deductions.

The partnership may also create nonrecourse deductions by a refinancing of property that has appreciated in value. If proceeds of a nonrecourse refinancing are not used to improve partnership property, and thereby increase the basis of partnership property, minimum gain may be created or increased.

ALLOCATIONS OF NONRECOURSE DEDUCTIONS

Because no partner bears the risk of loss associated with nonrecourse deductions (the nonrecourse creditor bears that risk), it is somewhat arbitrary how allocations of such deductions should be made. Thus, the regulations permit the partnership to allocate nonrecourse deductions in such a way that they will be "deemed" to be in accordance with the partners' interests. If the allocation follows the partners' interests, then it need not satisfy the substantial economic effect test.

To satisfy the "deemed" in accordance with the partners' interest test, the partnership agreement must contain the following three provisions:[82]

1. Capital accounts are maintained in accordance with the §704(b) regulations.
2. Liquidating distributions, throughout the term of the partnership, follow ending capital account balances.
3. The partnership agreement contains a minimum gain chargeback.

In addition to the three provisions listed above, it is also necessary that the allocation be reasonably consistent with a recourse allocation that satisfies the substantial economic effect test.[83]

SECTION 704(C) ALLOCATIONS

For contributions of property, a partnership is required to make tax allocations which prevent pre-contribution gains or losses from being shifted to the noncontributing partner.[84] Specifically, the partnership must allocate income, gain, loss, and deduction with respect to contributed property "so as to take account of the variation between the basis of the property and its fair market value at the time of contribution."[85]

Section 704(c) allocations are mandatory. Therefore, the practitioner must be familiar with the methods of making such allocations.

The general purpose of §704(c) is to ensure that the partner who contributes property with a built-in gain or loss is allocated that portion of a recognized gain or loss attributable to the pre-contribution gain or loss.

Section 704(c) is complicated by the need to adjust allocations, such as depreciation, that arise before the property is sold. Section 704(c) allocations are also complicated when tax items arising from a sale are insufficient to adequately compensate for the disparity between fair market value and tax basis of contributed property.

[82] Reg. §1.704-3(b)(2)(ii)(b).
[83] Reg. §1.704-2(e)(2).
[84] Sec. 704(c).
[85] P.L. 98-369, Tax Reform Act of 1984.

WHEN SECTION 704(C) IS NOT REQUIRED

The regulations allow the partnership to disregard the principles of §704(c) if the following requirements are satisfied:[86]

- For each item of contributed property, the fair market value does not differ from the adjusted basis by more than 15 percent of the basis; and
- The total disparity between fair market value and tax basis of all properties contributed during the year does not exceed $20,000. For this purpose, positive and negative differences must be summed; that is, they may not be netted.

Example 3-4

Two items of property are contributed to a partnership during the year. One has a fair market value of $100,000 and a tax basis of $89,000; the other a fair market value of $99,000 and a tax basis of $110,000. Both properties satisfy test 1 above. However, the combined disparity is $22,000. The small disparity rule does not apply, and both properties are subject to §704(c). This is so even though the total fair market value and total tax basis of the two contributed properties are equal ($199,000 total fair market value and basis).

GROUPING CONTRIBUTED PROPERTIES

Generally, the partnership must account for the disparity between fair market value and tax basis item by item. This requirement can be an incredible burden when a partner contributes numerous assets and may require an appraisal of each asset.

The regulations allow items, other than real property, that fall into the same general asset classification to be aggregated as a single item for §704(c) purposes. For example, contributions of items within the 7-year recovery class can be aggregated. Also, all property (other than real property) with a zero basis and certain inventory items may be aggregated.[87]

THREE METHODS SPECIFIED BY REGULATION

The three methods of making §704(c) allocations specified in the regulations are

1. The traditional method.[88]
2. The traditional method with curative allocations.[89]
3. The remedial allocation method.[90]

[86] Reg. §1.704-3(e).
[87] Reg. §1.704-3(e).
[88] Reg. §1.704-3(b).
[89] Reg. §1.704-3(c).
[90] Reg. §1.704-3(d).

The Traditional Method

In the traditional method, the partnership first records each partner's contribution at fair market value net of liabilities. This entry is referred to as book basis capital accounts. Tax basis capital accounts are recorded at the adjusted tax basis of contributed properties reduced by any liabilities transferred.

The difference between the book basis and tax basis capital accounts represents the amount that is subject to §704(c) allocations. That is, it is only when the fair market value and tax basis of contributed assets is not the same that there is a disparity to deal with through §704(c).

After recording the book and tax basis capital accounts, the §704(c) allocations with respect to contributed property should attempt to provide the noncontributing partner with the same tax allocation that she would have received had the tax basis and fair market value of the property been equal. That is, the book allocation, based on fair market value, and tax allocation, based on carryover basis, should be the same for the noncontributing partner.

The Traditional Method with Curative Allocations

The traditional method for a §704(c) allocation is believed by some to be deficient when the *ceiling* rule applies. We will soon present an example in which the tax basis of contributed property is insufficient to allocate an amount of depreciation to the noncontributing partner equal to what such partner would have received if the property had a contributed basis equal to its value. Because the available tax depreciation is a *ceiling* on the amount that may be allocated, the noncontributing partner then appears to be cheated by the traditional method.

A curative allocation attempts to *cure* the defect caused by the ceiling rule by making an allocation of some other item of income or deduction that has the same tax character as the item limited by the ceiling rule.

The following example illustrates the application of the traditional method when the ceiling rule does not apply. The example is then modified to illustrate the problems created by application of the ceiling rule.

Example 3-5

In formation of the MJ partnership, Mary contributes $100,000 of cash and Jim contributes equipment with a basis of $60,000 and a fair market value of $100,000. Assume that the equipment is depreciated at a rate of 20 percent each year, and it is agreed that all items will be shared equally. If the property is sold immediately after contribution, the $40,000 gain must be allocated to Jim. If, however, the equipment is held by the partnership, there must be some adjustment to depreciation to reflect the low basis, relative to fair market value, which deprives Mary of her fair depreciation share.

The depreciation can be divided into that reported on the tax return, $12,000 each year (.20 × $60,000), and that recorded on the basis of fair market value, $20,000 each year (.20 × $100,000). The allocation to Mary should be one-half of the depreciation as determined using fair market value, or $10,000. Jim receives whatever amount remains, or $2,000.

Notice that if the asset is held for five full years, such that it is fully depreciated, the original $40,000 difference between fair market value and basis has been equalized between the partners. Mary has received tax depreciation allocations of $50,000, and Jim $10,000.

Assigning an extra $40,000 of deductions to Mary has the same effect as assigning the first $40,000 of gain from sale to Jim. If the property is sold for $10,000 after the fifth year, the tax gain of $10,000 is split equally. If the property is sold after the second year, the depreciation allocations have given Mary an extra $16,000, such that the first $24,000 of gain is still allocated to Jim.

To see this, compare book basis and tax basis capital accounts at different times:

	J Book	**M Book**	**J Tax**	**M Tax**
Beginning	100	100	60	100
Yr 1-2 Dep.	< 20>	< 20>	< 4>	< 20>
Balance	80	80	56	80

After year 2, Jim's book capital account exceeds his tax capital account by $24 (80 – 56). This is the §704(c) adjustment remaining after the first two years' depreciation adjustments. Now assume the property is sold for $70. The book gain is $10 (book basis is now $60, after $40 of depreciation). The tax gain is $34 (tax basis is $60 minus the $24 tax depreciation, or $36).

The first $24 of tax gain is allocated to Jim, the rest is split $5 to each partner. The book gain is split $5 to each. Notice that Jim's capital account now becomes $85 for book and tax, the same as Mary's. The partnership should have $170 to distribute (the sale proceeds of $70 plus Mary's cash of $100, which, for simplicity, we have assumed was not touched), which is split equally. The following reconciliation of capital accounts shows how the §704(c) disparity is eliminated.

	J Book	**M Book**	**J Tax**	**M Tax**
Beginning	100	100	60	100
Yr 1-2 Dep.	< 20>	< 20>	< 4>	< 20>
Gain	5	5	29	5
Distribution	< 85>	< 85>	< 85>	< 85>
Balance	-0-	-0-	-0-	-0-

If the property is instead held for five years, the capital accounts are $50 all the way across:

	J Book	**M Book**	**J Tax**	**M Tax**
Beginning	100	100	60	100
Yr 1-5 Dep.	< 50>	< 50>	< 10>	< 50>
Balance	50	50	50	50

Any gain, and cash, from sale would be split equally for both tax and book purposes.

The problem with the traditional method arises when the ceiling rule applies, as shown in the following variation to the facts of the preceding example.

Example 3-6

Assume the same facts as in the preceding example, except that Jim's property has a tax basis of only $40,000 at the time of contribution. The tax depreciation is then limited to $8,000 each year, and Mary receives all of the depreciation. Even after five years, the full amount of the §704(c) adjustment, which is $60,000 in this variation, is not eliminated. The first $20,000 of gain ($60,000 minus $40,000 already reflected in additional depreciation to Mary) would be allocated to Jim, even after five years. (You should be able to show that Jim's book capital account is $50,000 after five years, but his tax capital is still $40,000. Mary's book capital account is $50,000, but her tax capital is $60,000. The sum of the disparities between the book and tax capital accounts, $20,000, is the §704(c) adjustment remaining after five years.)

	J Book	M Book	J Tax	M Tax
Beginning	100	100	40	100
Yr 1-5 Dep.	< 50>	< 50>	< 0>	< 40>
Balance	50	50	40	60

The ceiling rule, shown above, led to the adoption of the traditional method with curative allocations as a possible allocation method for §704(c) purposes.

In the traditional method with curative allocations, any adjustment that cannot be reflected currently because of the ceiling rule is cured with an item allocation that has the same effect on the partners as the tax items affected by the ceiling rule. For example, an allocation of sales income to offset a depreciation allocation is permitted, because both items affect ordinary income or loss.

Example 3-7

Continuing the facts of the immediate preceding example, in which the ceiling rule applied, the partnership could allocate $4,000 of income to Jim each year in addition to the $8,000 depreciation allocation to Mary. The combined effects of the two allocations would cure the required §704(c) allocation. After five years, Jim's book and tax capital accounts would each be $50,000, as would be Mary's. To see this, recognize that, absent the $4,000 item allocation of income, both Jim and Mary would have been allocated $2,000 of income. The curative allocation then gives Jim $2,000 more, and Mary $2,000 less, than would have occurred under the traditional method. Five years of an additional $2,000 allocation to Jim raises his tax capital account by $10,000 relative to the prior example; Mary's similarly is reduced by $10,000. Alternatively, the $8,000 depreciation allocation to Mary, combined with the $4,000 income allocation to Jim, creates a $60,000 disparity in allocations over five years, the exact amount of the precontribution gain inherent in Jim's asset.*

The capital accounts that follow assume that the partnership has a $4,000 item of income each year. Without the curative allocation, the income would be allocated $2,000 to each partner for both book and tax purposes. Thus, in the capital accounts as shown in the preceding example, both book capital accounts would be

$60 after five years (that is, they would each be increased by a total of $10), and Jim and Mary's tax basis capital accounts would be $50 and $70 respectively, having each also been increased by $10 over five years.

The curative allocation would apply for tax purposes only, and would give Jim all $4,000 of income. After five full years, the partners' book and tax capital accounts are equal and there is no further need to make §704(c) allocations.

	J Book	**M Book**	**J Tax**	**M Tax**
Beginning	100	100	40	100
"Cure"	10	10	20	-0-
Yr 1-5 Dep.	<50>	<50>	-0-	<40>
Balance	60	60	60	60

[*] Reg. §1.704-3(c).

The curative allocation seems to fix the problem created by the ceiling rule. However, one concern is what items the partnership can choose to make the curative allocation with. It is clear that an item of income that would be classified as part of ordinary income or loss can be used. What is not clear is to what extent a separately stated item of income can be used. Item allocations of separately stated items to cure a depreciation allocation can open the door to abuses because the allocation may have a second tier effect on partners' tax liabilities above that of the required §704(c) adjustment.

The Remedial Allocation Method

The remedial allocation method involves the creation of notional items of income and loss. The sum of the *created* income and loss items is zero, so that partnership taxable income is not affected by the notional item. In effect, the partnership simply makes up an item of income and loss to allocate to the partners.

To understand the remedial method, refer to the preceding example. The ceiling rule prevented an allocation of tax depreciation to partner Mary equal to her book depreciation allocation. As one alternative, we show how a curative allocation could fix the problem created by the ceiling rule. But as discussed in the text accompanying this example, the partnership may not have an item of a similar character to use as a curative allocation.

The remedial allocation method allows the partnership to simply invent an item to fix the ceiling rule problem.

Using the facts of the preceding example, if the partnership chooses the remedial allocation method, it will create a notional item of $2,000 of income and $2,000 of deduction with the same character as the depreciation deduction that is limited by the ceiling rule. Mary will receive an allocation of a $2,000 deduction; Jim will receive an allocation of $2,000 of income.

	J Book	M Book	J Tax	M Tax
Beginning	100	100	40	100
Yr 1 Dep.	<10>	<10>	-0-	<8>
Remedial	N/A	N/A	2	<2>
Balance	90	90	42	90

The difference between the remedial method and the curative method is that the remedial method allows the creation of an item that the partnership does not actually incur. The sum of the created income and deduction must be zero. Thus, partnership income and the basis of partnership assets are not changed by the notional items. However, Mary's tax basis capital account is reduced by an additional $2,000 each year Jim's is increased by $2,000, equating both partners' book and tax capital accounts. (The remedial allocation does not affect book basis capital and thus has no effect on the partners' rights to partnership assets on liquidation.) Mary will deduct the $2,000 notional deduction on her tax return and the basis of her partnership interest will be reduced. Jim will include the $2,000 notional income on his tax return and the basis of his interest will be increased.

Cash Basis Partnerships and Varying Interests

If a partnership reports on the cash method, it is possible that an allocation of income based on varying interests may produce a windfall to a partner who acquires an interest at the end of the tax year. This is so because an interim closing of the books will result in an allocation to the new partner of all deductions for cash basis items paid after the change in interests.

Example 3-8

The TYZ partnership admits new partner Z with a 10 percent interest on December 15th. TYZ reports on the cash basis and will make a $1,000,000 interest payment on December 31. The interest has accrued throughout the entire year. If the interim closing of the books is used, partner Z would be entitled to 10 percent of the interest deduction, although he has only been a partner for one-half of December.

The use of the cash method and an interim closing of the books provided a strong incentive for high tax bracket taxpayers to join a tax shelter partnership at the end of the tax year. If cash basis items were paid at the end of the year, a new partner could receive a large deduction although he had only been a partner for a short period of time.

In response to this perceived abuse, the law provides that *allocable cash basis items* must be assigned to the day to which they are attributable and allocated to partners who held interests as of that date. This change, which effectively places the partnership on the accrual basis for designated items, covers interest, taxes, and payments for the use of property.[91]

If a change in interest occurs due to a sale, exchange, or liquidation of a partner's entire interest in the partnership, the partnership tax year will close with respect to that partner. For partnership tax years beginning after 1997, the death of a partner will also result in a closing of the tax year with respect to the decedent. This does not mean that the partnership is considered terminated,

[91] Section 706(d)(2).

only that the tax year is deemed closed for purposes of determining the income or loss to be allocated to the partner who disposed of his entire interest.

Generally, an interim closing of the books is required for this allocation, but a pro rata allocation can be made if the partners agree to do so.[92] Since a *pro rata* allocation requires significantly less work, the partnership agreement should provide for such an allocation if this is the intent of the partners.

Retirement Plans

Prior to 1982, retirement plan needs often resulted in the choice of the corporate form in order to take advantage of the maximum amount of deferral into a qualified plan. Since 1982, self-employed (Keogh) plans have had the same options as corporate plans. However, the specific calculation and placement of the deduction differ in the case of a self-employed plan. The contribution for the self-employed plan is taken on the owner's Form 1040 as a for-AGI deduction. Unlike the case of other fringe benefits such as self-employed health (described in the next section) a 2 percent shareholder in an S corporation is not treated as a partner for retirement plan purposes.

Across the gamut of retirement plans, it is important that the business be aware that rules will apply that are designed to ensure that all employees have the opportunity to benefit from the plan and that highly compensated employees do not receive all of the benefits.[93] In the case of a self-employed plan, the contribution percentage of the owner is based on a formula and is applied to earnings from self-employment. Formally, the owner's income for this purpose is the SE earnings less the contribution to be made for the owner and one-half of the SE tax. The IRS has simplified the application of this circular formula through the use of a table which can be found in Publication 560. For example, if the self-employed owner provided a SEP plan with a 25 percent standard employee contribution, the owner's contribution would be based on 20 percent of the earnings not including the contribution.

Some additional plan considerations include the following:

- SEP plans allow for plan adoption as late as the due date of the employer's return.
- A SIMPLE may be more cost effective for the owner, given the combination of elective deferral and relatively low employer contribution percentages.
- For cash-cow businesses in which family members are the only employees, a defined benefit plan may be a good option.
- Even though partners are treated as self-employed, a plan for partners must be established by the partnership, which is considered an employer for this purpose.

[92] Reg. §706-1(c)(2)(ii).
[93] If the business wishes to adopt some form of top-heavy plan (accrued benefits for the highly compensated are more than 60 percent of the total benefits), consultation with an expert in the area is key.

- The deduction for retirement contributions made for a partner is to be allocated to that partner.[94]

Fringe Benefits

Generally, fringe benefits provided to a partner will be taxed to the partner as a guaranteed payment. However, the specific provision allowing for a fringe benefit may provide that it will be allowed as a tax-free fringe to the partner. Therefore, it is important that if the availability of a particular fringe benefit is critical to the owner, the availability of the fringe should be researched in the appropriate Code section to determine its availability.

The most common fringe benefit issue affecting entity choice involves the deduction for medical plan payments. Obviously a sole-proprietor is subject to the self-employed health deduction rules. In addition, 2 percent shareholders (treated as partners)[95] and partners are also treated as self-employed for this purpose. A 2 percent shareholder is one who owns over 2 percent of the stock or over 2 percent of the combined voting power of stock on any day of the tax year.

Revenue Ruling 91-26, 1991-1 CB 184 provides that accident and health insurance premiums paid by the S corporation for the benefit of 2 percent shareholders are treated in the same manner as guaranteed payments are for a partner. This means the corporation gets a deduction as if it was making a fringe benefit payment, and the premiums are included in the shareholder-employees' W-2s as taxable income but not typically subject to Social Security and Medicare taxation.[96]

While §106 does provide an exclusion for employer-provided coverage under an accident and health plan, the notice reminds taxpayers that 2 percent shareholders are not considered employees for §106 purposes, so the amounts cannot be excluded from taxable income.

However, §162(l)(1)(A) allows an individual who is an employee within the meaning of §401(c)(1) to take a for-AGI deduction for amounts paid during the tax year for medical insurance payments for taxpayer, spouse, and dependents. This is commonly referred to as the self-employed health deduction. As such, amounts are not allowed if they exceed earned income from the business. The notice reminds taxpayers that this deduction is not allowed for amounts during a month in which the taxpayer is eligible to participate in an employer plan. This disqualifying coverage can come from potential coverage by an employer of either the taxpayer or spouse.

Case Study 3-1: Income and Cash Flow Priority

Facts

Reed Hardy is a real estate developer who has actively sought property along the U.S.-Mexico border to take advantage of certain opportunities that Reed believes have been created by the passage of the North American Free Trade Agreement. Reed has located some property which he

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[94] This is based on Regulation §1.404(e)-1A and is not overridden by allocation mechanisms in the partnership agreement.

[95] §1372(a).

[96] In addition, a partnership (but not an S corporation) could account for the premiums by reducing the partner's distributions. This method involves the partnership not taking a deduction for the premium, and the partners (all) would not have an effect on their distributive shares based on the premium.

believes would be ideal for development to include a shopping center, warehouse facilities, and office buildings. Reed requires $10 million in investment capital, of which Reed can afford to invest $500,000 personally.

Reed has many investors whom he has called on in the past to work with him, and he believes that he will have no problem raising $9.5 million in investment capital. Reed will acquire a 5 percent interest as a manager of the proposed project. The investors will receive the other 95 percent ownership interests. Reed's proposal is that distributions of cash and allocations of profit and loss be made in the 5 to 95 ratio of ownership interests. However, Reed believes that he should receive a priority distribution of cash, to be matched with income, to compensate him for his efforts in locating the property and initiating the development ideas. He proposes that he receive a $100,000 priority distribution. This is in addition to a reimbursement for all costs that he has incurred on behalf of the investment venture.

Discussion

If Reed intends to carry out his plan using an S corporation, and if all contributions will be in exchange for stock to be held in a 5 to 95 ratio, the priority distribution to Reed will risk loss of the S election. S corporations may have only one class of stock.[97] An S corporation will have only one class of stock if all outstanding shares confer identical rights to distributions during the life of the corporation and to distributions upon liquidation of the entity.[98] The governing provisions of the corporation, which include the corporate charter, bylaws, articles of incorporation, and related items, determine whether outstanding shares confer identical rights.

A distribution to one shareholder that is not matched in time with a distribution to another shareholder does not necessarily create a second class of stock. Letter Ruling 9519048 held that a disproportionate distribution in one year that was intended to be corrected by a distribution in another year would not create a second class of stock because the initial distribution was not a result of the governing provisions of the corporation. Similarly, Reg. §1.1361-1(l)(2)(v), Example 2, allows a corrective distribution in a later year.

The problem with Reed's proposal is that there will be no corrective distribution. Reed will receive a permanent distribution that is disproportionate, and this distribution will be by agreement with the other shareholders. Such a distribution will almost certainly create a prohibited second class of stock. Another problem with Reed's proposal, if it is to be effectuated through an S corporation, is that the distribution cannot be matched by a profit allocation. S corporation items must be allocated per-share, per-day, and Reed will not be able to receive a special allocation of $100,000 of profit.

Of course, there are other ways to allow one individual to receive some economic benefit not enjoyed by others. These other ways have their own tax consequences. This Case Study focuses on the allocation issue as a way to achieve Reed's goals and does not necessarily address all other possibilities to achieve Reed's goals. For example, Reed could receive a guaranteed payment for services.

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[97] Section 1361(b)(1)(D).

[98] Reg. §1.1361-1(l)(2)(i).

Reed may satisfy his objective in several ways. First, he may use a partnership or an LLC as the operating entity for his venture. If Reed's interest is 5 percent, he may still receive a special allocation of the first $100,000 of profits, which allocation may be matched with a priority distribution of cash flow. Although all allocations other than this first $100,000 will follow the 5 to 95 ownership split, and would therefore appear to be general allocations that do not need to satisfy the substantial economic effect test, the priority profit and cash-flow allocation will mean that Reed's interest is *more than 5 percent*. As a result, the LLC operating agreement or the partnership agreement would need provisions to ensure that all allocations satisfy the substantial economic effect test.

An LLC structured as a manager-managed (not member-managed) entity under relevant state law will allow Reed to be the managing member with the investors functioning as passive non-manager members. Similarly, a partnership may be structured with Reed as the sole general partner and the investors as limited partners. Either alternative would allow Reed to control the management of the venture. However, to limit his personal liability, Reed will best be served by use of an LLC.

Reed may seek to replicate the benefits of a partnership (or LLC) special allocation by use of debt in the S corporation's capital structure. If Reed loans the corporation $100,000, and contributes $400,000 in exchange for stock, he will acquire a priority on corporate cash flow to repay his debt. Reed's stock ownership will be 4.04 percent ($400,000 to $9,900,000) and he will be entitled to a slightly lower profit share and share of distributions made with respect to stock (rather than debt).

It has often been suggested that shareholder loans create priorities to cash flow of an S corporation that have some characteristics of special allocations in partnerships. Although there is some truth to this statement, Reed's goals may best be met by use of a limited partnership or an LLC. For liability protection reasons, the LLC appears to be the best choice.

It is important for Reed to recognize that the priority rights to cash flow and income that he proposes will create a special allocation in a partnership or an LLC, notwithstanding the fact that all other distributions and profit and loss allocations will be in the 5 to 95 ratio of initial contributions. Thus, the LLC operating agreement will need to be drafted with the substantial economic effect test in mind, and capital accounts will need to be maintained in accordance with Reg.1.704-1(b)(2)(iv).

Case Study 3-2: Using Special Allocations

Facts

Gina McWater proposes to purchase several apartment complexes in an area that has very high occupancy rates and has significant investment potential for income producing real property. Gina has identified prospective investors for her projects and she has received the following feedback from the investors:

- Many of the investors are interested in tax losses; some have concerns about passive loss limitations but others state that they have sufficient passive income to absorb passive losses. [Because the average lease term will exceed 30 days and there will be no extraordinary services provided, the apartments will be subject to the automatic passive

classification under the §469 regulations. Some of the investors may qualify as real estate professionals as that term is defined in §469(c)(7), which will exempt them from the automatic passive rule for real estate rentals, but Gina proposes to be the sole manager of the venture so that none of the investors could satisfy a material participation test with respect to the ventures.]

- The investors are willing to commit sufficient initial capital to support at least a 20 percent down payment on all income producing properties.
- The investors want 99 percent of the tax losses.

In addition to the above information, Gina notes that financial institutions in the area will loan on a nonrecourse basis if the borrower makes a 20 percent or greater down payment and if the property supporting the loan is income-producing real estate. This is so because the vacancy rate on an apartment complex is approximately 6 percent. All prospective investors insist that their liability be limited to their investment and not include any liability for borrowings of the venture. Gina insists on managing the venture and all of the investors are willing to allow her to do so.

Discussion

There are several factors that suggest that a limited partnership or an LLC are the only viable entity choices for this fact pattern. First, the investors are interested in special allocations of losses; that is, the deal may sell better if the investors are promised a share of losses that exceeds their proportionate ownership shares. Second, to have sufficient tax basis to claim any losses that flow through, the investors must be able to include any nonrecourse borrowings of the entity in the basis of their ownership interests.

It should be clear that a C corporation is not a possible option for this fact pattern. The investors not only want tax losses to pass through to their personal tax returns, but it should be implicit that the investors do not want to incur two levels of tax as would occur in a C corporation.

If the investment is to be conducted through a flow-through entity, we have three options to consider:

1. An S corporation.
2. A limited partnership (a general partnership is ruled out because the investors will not participate in management and insist that their liability be limited).
3. A limited liability company.

There are two problems with the use of an S corporation. First, allocations of profit and loss from an S corporation must be per-share, per-day; that is, they must be proportionate to ownership interests.[99] It is not possible to make special allocations of losses to one or more of the owners. Second, even if the investors were willing to accept a proportionate share of losses of the entity, they will quickly run out of tax basis to claim those losses, notwithstanding the ability to clear any passive loss hurdle. Section 1366(d) states that shareholders may not take any loss from an S corporation into account in determining their taxable income unless they have sufficient basis in

[99] Sections 1366(a)(1) and 1377(a)(1).

stock and debt of the S corporation. A shareholder has basis in debt of the S corporation only if that shareholder has made the loan. Because Gina (and the investors) proposes to borrow from a third-party financial institution and not from the shareholders (who would not want to risk the capital), the shareholders' basis for loss purposes will be limited to their stock investment. This basis will not allow for substantial tax losses to be claimed.

The fact that Gina wants to manage the entity should not suggest that a limited partnership is more favorable than an LLC. If a limited partnership is the chosen form, and Gina is named as the general partner, she will, by definition, manage the entity. However, Gina will also have unlimited liability as a general partner. It would then be advisable for Gina to use a corporation (S corporation for flow-through benefits) or an LLC as the general partner.[100]

If an LLC is selected, Gina may be named as the managing member and the investors would be named as nonmanaging members. For example, the operating agreement may specify that there will be class A and class B members, and management authority is vested in the class A interest.

The optimal solution is likely to be an LLC because Gina may achieve limited liability without the need to establish a corporate general partner. The costs of establishing the LLC will be greater than "normal" because the operating agreement must satisfy the requirements of Regs. §1.704-1(b) for the special loss allocations to satisfy the substantial economic effect test. Because the investors want limited liability, the alternate test for economic effect should be met. This test does not require assumption of an obligation to restore a deficit capital account balance on liquidation of an owner's interest. The economic effect test will apply only to the recourse deductions generated by the entity. Because the entity proposes to borrow on a nonrecourse basis, some of the deductions may be nonrecourse. Such deductions may be allocated by agreement provided the *deemed in accordance with the partners' interests* test of Regs. §1.704-1(b) is met. Satisfying this test will require some additional wording in the operating agreement.

Case Study 3-3: Allocations with Respect to Precontribution Gain or Loss

Facts

Paul and Katie intend to form an entity with Paul contributing depreciable property with a fair market value of $300,000 and a tax basis of $100,000 and Katie contributing $300,000 of cash. The parties intend that all tax items will be shared equally. Each owner will receive a 50 percent interest, proportionate to the value of the property contributed to the entity. Paul's property may be assumed to be depreciated at the rate of 20 percent each year for book and tax purposes.

The entity will operate a business in which Paul's contributed property will be used. Both Paul and Katie would like the entity to limit their personal liability to the amount that they have invested, and they want to avoid two levels of tax. Both owners will actively manage their investment in the business. They anticipate that the business will produce immediate profits, so that the ability to include entity borrowings in tax basis for the purpose of claiming tax losses is not expected to be an issue.

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[100] Note that Gina could use a single-member LLC and take advantage of the provisions of Reg. §301.7701-3(b)(1)(ii) which treats a single (individual) member LLC as a disregarded entity for tax purposes.

Discussion

Paul and Katie should consider an S corporation and an LLC. A general partnership would not be appropriate because both owners want to limit their personal liability. Of course, an LLC may not be a choice in all states depending on what type of business Paul and Katie intend to operate. A limited partnership is not viable because both owners want to actively participate in management.

Because all profits and losses are to be split equally, in proportion to ownership interests, there is no need to consider the benefits available from special allocations in the LLC form. However, Paul and Katie need to be aware of the mandatory §704(c) allocations with respect to Paul's contributed property. These allocations may be favorable or unfavorable, based upon how the parties view the costs and benefits.

Section 704(c), applicable to partnerships and LLCs taxed as partnerships, requires that allocations attributable to property contributed to a partnership with a fair market value different from its tax basis take into account the precontribution gain or loss. This means that when such property is sold by the partnership, the contributing partner must be allocated any portion of the gain or loss that relates to precontribution gain or loss. Also, if the property is depreciable, deductions for cost recovery must be allocated giving consideration to precontribution gain or loss. How this may be done will be illustrated below. But for now, it is important to understand the following costs and benefits of such an approach.

Section 704(c), which relates to allocations of income, deduction, gain, and loss attributable to property contributed to a partnership with a fair market value different from its tax basis, is mandatory and overrides any agreement among the partners. It can be good if it more properly allocates items in accordance with the economics of a deal, but it can be bad if the compliance costs are very high. S corporations avoid §704(c) allocations entirely. Whether the S corporation or the partnership approach to such allocations is best depends on facts and circumstances.

1. The partner who did not contribute §704(c) property (Katie in our example) will receive a tax benefit (detriment) when contributed property has precontribution gain (loss). For example, if Paul's property is sold shortly after formation of a partnership, the entity must report a $200,000 gain.[101] Without §704(c), both Paul and Katie will recognize 50 percent of this gain (per their proposed agreement). Thus, Katie suffers a tax detriment because she must report gain that is properly attributable to Paul's holding the property and not to any gain that occurred when the partnership held the property. Because the partnership's depreciable basis for Paul's property is only $100,000, Katie also suffers a detriment because cost recovery deductions are based on the depreciable basis and not the fair market value of the contributed property (note that Katie gave Paul credit for a $300,000 contribution).

2. Subchapter S requires that all allocations be made per-share, per-day. Thus, if Paul and Katie form an S corporation, the detrimental result (to Katie) shown in the preceding paragraph will occur. Such a result may be avoided if the transfer is to an LLC.

[101] Section 723 states that the partnership's basis shall be the contributing partner's basis.

3. The ability to avoid the detriment to the noncontributing owner if the transfer is to an LLC will come at a compliance cost. It is not easy to account for many §704(c) allocations, and the LLC may expect that professional fees to prepare a tax return will be higher when complex §704(c) allocations are involved.

To illustrate point 3, and also to show how the detriment to Katie may be avoided by use of an LLC, let us review how §704(c) will affect the proposed property transfer.

Section 704(c) allocations may best be understood by comparing book and tax adjustments to capital accounts when property is contributed with a fair market value different from its tax basis.

Book capital accounts will be recorded by crediting each partner with the fair market value of contributed property. Tax basis capital accounts will be recorded by crediting each partner with the basis of property contributed. Thus, initial capital accounts are (000s dropped):

	Book		**Tax**	
	Paul	**Katie**	**Paul**	**Katie**
Initial Contribution	300	300	100	300

Book cost recovery deductions are based on the fair market value of the property; tax cost recovery is based on the partnership's tax basis for the property, which will carry over from Paul. Thus, (dropping all 000s), book cost recovery is $60 each year and tax cost recovery is $20 each year.

Regulation §1.704-3 provides three alternative methods of making §704(c) allocations—the traditional method, the traditional method with curative allocations, and the remedial method.

The traditional method will split book depreciation equally, as provided in the agreement between Paul and Katie. Tax depreciation will be allocated to Katie up to the amount of her book depreciation.[102] Because tax depreciation is only $20 each year, it is not possible to make an allocation of the $30 book depreciation to Katie. The *ceiling* rule applies in this example because tax depreciation is insufficient to fully compensate the noncontributing partner for the depreciation that she would have received had the property been contributed with fair market value equal to basis. The ceiling rule means that one cannot allocate more tax items than exist. The ceiling rule problem shown in this example may be corrected with a curative allocation or a remedial allocation, both discussed in the following text.

After the first year, and assuming no income or loss from operations, the capital accounts would be:

	Book		**Tax**	
	Paul	**Katie**	**Paul**	**Katie**
Initial Contribution	300	300	100	300
Year 1 Depreciation	< 30>	< 30>	-0-	< 20>
End Year 1	270	270	100	280

102 Reg. §1.704-3(b)(1).

The traditional method creates a disparity of $10 between Katie's book and tax capital accounts.

The traditional method with curative allocations allows the partnership to make an allocation for tax purposes that differs from a corresponding allocation for book purposes.[103] The application of the ceiling rule to Paul and Katie's situation resulted in an allocation of depreciation for tax purposes to Katie that differed from a corresponding allocation of book depreciation ($20 for tax and $30 for book). The disparity may be *cured* by an item allocation of some related items of partnership income or deduction. For example, the partnership could allocate additional depreciation from other partnership property to Katie. Alternatively, the partnership could allocate additional income to Paul. Either allocation may cure the disparity created by the ceiling rule as applied to the traditional method.

Tax depreciation creates a tax benefit for the partner to whom such depreciation is allocated. If the traditional method cannot fully cure the §704(c) disparity between book and tax items, the noncontributing partner may have another item of deduction allocated to him or her (resulting in a tax benefit) or the agreement may allocate items of income away from such partner (avoiding the tax detriment of the income).

Regs. §1.704-3(c)(3)(iii) requires that a curative allocation have substantially the same effect on the partner's tax liability as the item limited by the ceiling rule. A curative allocation of an item of ordinary income or loss with a separately stated item may not be reasonable under this rule.

Assume that the partnership has an item of ordinary income (from operations) of $20 to allocate between Paul and Katie. Recall that when the traditional method is used, the income is split equally between Paul and Katie for both book and tax purposes. Capital accounts at the end of Year 1 then appear as

	Book		**Tax**	
	Paul	**Katie**	**Paul**	**Katie**
Initial Contribution	300	300	100	300
Income Item	10	10	10	10
Year 1 Depreciation	< 30>	< 30>	-0-	< 20>
End Year 1	280	280	110	290

Without any curative allocation, Katie's book and tax capital accounts differ by $10, the same difference found above (without the income item).

The curative allocation would be designed to equate Katie's book and tax capital accounts, requiring a shift of $10 of income from Katie to Paul for tax purposes. Because the traditional method would split the income equally, the effect of the curative allocation is to allocate to Paul the entire $20 of income. Capital accounts then appear as follows:

[103] Reg. §1.704-3(c)(1).

	Book		Tax	
	Paul	**Katie**	**Paul**	**Katie**
Initial Contribution	300	300	100	300
Income Item	10	10	20	-0-
Year 1 Depreciation	< 30>	< 30>	-0-	< 20>
End Year 1	280	280	120	280

The income item allocation has eliminated the difference between Katie's book and tax basis capital accounts. Note that if we continued to make the same allocations for each of the first five years, Paul's tax and book basis capital accounts would equal $200 at the end of Year 5, and Katie's tax and book basis capital accounts would also equal $200 at the end of Year 5. If the property contributed by Paul were sold at the end of Year 5, no §704(c) allocation would be required because the disparity had been fully eliminated by the traditional allocation of depreciation and the curative allocation of income.

The difficulty in using the curative method is that the item used to cure the defect created by the ceiling rule must be of the same tax character as the item being cured. That is, it is not appropriate to use a §1231 gain to cure a cost recovery item. The partnership may not have sufficient items of the same character to cure a ceiling rule item. To deal with this possibility, Reg. §1.704-3 permits use of the *remedial method*. A remedial allocation involves the creation of a notional item to cure the ceiling rule problem.

The difference between the remedial method and the curative allocations is that the remedial method allows the partnership to simply invent an allocation, solely for tax purposes, to offset the ceiling rule problem. Because the partnership cannot actually invent net income or deductions, the notional items of income and deduction must add to zero. For example, assume that the partnership formed by Paul and Katie did not have any items to cure the ceiling rule concern of the traditional method. The capital accounts using the traditional method appeared as follows:

	Book		Tax	
	Paul	**Katie**	**Paul**	**Katie**
Initial Contribution	300	300	100	300
Year 1 Depreciation	< 30>	< 30>	-0-	< 20>
End Year 1	270	270	100	280

The remedial method would involve the creation of a $10 item to cure the ceiling rule problem. This will require an allocation of a $10 tax deduction to Katie and an offsetting $10 income allocation to Paul. There is no book entry made and the notional items will have no effect on the basis of partnership assets. Capital accounts then appear as follows:

	Book		Tax	
	Paul	**Katie**	**Paul**	**Katie**
Initial Contribution	300	300	100	300
Remedial Allocation			10	< 10>
Year 1 Depreciation	< 30>	< 30>	-0-	< 20>
Without Remedial Allocation	270	270	110	270

If both the depreciation adjustment and the remedial adjustment are made for the remaining four years of the depreciable life of Paul's property, book and tax capital accounts will be $150 for both of the partners.

Thus, §704(c) takes into account the difference between fair market value and tax basis of Paul's contributed property. While the results may well be more fair to Katie, they come at a cost to both Paul (who suffers a tax detriment to offset Katie's benefit) and to the partnership (professional fees to handle the labor shown in the Case Study).

An S corporation may be desirable in certain cases to avoid the §704(c) complications shown above. Of course, whether it is better to live with §704(c) in an LLC or to select the S corporation form depends on the parties involved. The practitioner needs to discuss this issue with Paul and Katie, together with other differences between the S corporation and LLC form. Ultimately, it is the owners' decision what to make of the information provided by the CPA.

Case Study 3-4: Payroll Tax Comparison

Facts

The Johnson family operates an auto body shop as a proprietorship (Kal Johnson is the owner). The family wants to transfer the business to an entity for liability protection and to transfer ownership interests to family members. Capital is a material income producing factor, and any allocations from a flow-through entity will be proportionate to ownership interests. Kal Johnson proposes to transfer equity interests to each of his four adult children. Each of the children will work in the business. However, Kal insists on being the sole manager of the business.

Discussion

Kal will be the sole manager of the business regardless of the form of entity selected. If an LLC is used, the children may be given interests that have no management authority, with Kal designated as the sole member-manager. If a limited partnership is used, Kal could retain a general partnership interest and give limited partnership interests to the children. If an S corporation is used, the children may be given nonvoting stock without creating a second class of stock. Nonvoting stock could also be used in a C corporation.

The Johnson family may attempt to minimize or eliminate payroll taxes by selecting one of the following forms of entity and adopting the following strategy:

> Either an LLC or an S corporation may reduce payroll taxes relative to a C corporation. In a C corporation, the family has an incentive to pay a large amount of compensation to avoid a corporate tax. In an S corporation, the incentive is to pay small amounts of compensation, but the IRS may challenge the amounts designated. In an LLC, the member-manager will pay SE tax on all trade or business income but the non-managing members may avoid SE tax if there are no guaranteed payments (otherwise, SE tax is imposed only on the guaranteed payment). Reliance on the proposed regulations may be challenged.

1. Form an S corporation and pay only the least reasonable amount of compensation for services. It is unreasonable to pay no compensation if services are provided. There are several concerns to address if this strategy is to be adopted. First, the IRS may determine the shareholder-employee compensation to be greater than is claimed. Second, §1366(e) requires that family members be fairly compensated for services to avoid shifting income to other family members. For example, Kal could shift income to the four children by claiming less salary than is reasonable. Third, less compensation means less in retirement plan contributions, assuming that the entity has an interest in retirement planning for the family members.

2. Form an LLC and name Kal as the member-manager. Kal will be subject to self-employment tax on his distributive share of any income that is attributable to the conduct of a trade or business. The four children may argue that, as nonmanaging owners, they need to pay self-employment tax only on guaranteed payments. The same result will occur if a limited partnership is created and Kal is named as the general partner. However, an LLC will provide Kal with the liability shield that he desires.

Case Study 3-5: Rewarding Service Providers for Future Profits of the Entity

Facts

Paul and Kim have operated an auto repair business as general partners. They would now like to transfer business assets to an entity that will provide them with a liability shield. Paul and Kim have 13 employees, and they are interested in providing three key employees with profit participation in the new entity. They do not want the key employees to have to pay anything to acquire an equity interest, and they want to restrict the employees' rewards from this plan to future profits of the business. That is, there is no plan to give the employees an interest that would have immediate value even if the entity earned no profits. They also want to avoid any tax problems for the employees when the profits interests are transferred.

Discussion

The requirement that the entity provide the owners with a liability shield suggests a corporation and an LLC as possible entity choices.

Formation of an LLC with transfers of profits interests to the key employees would meet all of the goals identified by Paul and Kim. The IRS has now conceded that there is no tax consequence from receipt of a purely profits interest in a partnership.

Given the goals of the compensation plan, it would appear that an LLC would be a good choice for this business. Because an LLC is taxed as a partnership, Paul and Kim could grant the key employees a profits-only interest in the LLC. That is, the employees will receive no credit to their capital accounts. The capital accounts should determine each member's share of the assets upon a liquidation of the entity. By not transferring any capital to the three employees at the time that the profits interests are given, Paul and Kim ensure that the only way that the employees will benefit from the plan is if the business earns profits in future years. Therefore, a profits interest in an LLC satisfies the economic objectives of the owners' plan.

Paul and Kim have also said that they do not want employees to suffer any negative income tax consequences from the interests in future profits. The IRS has conceded, in Revenue Procedure 93-27, that a profits interest in a partnership will not be taxable at the date of receipt unless one of three exceptions applies. The only relevant exception in this situation would arise if one of the employees sold his or her interest within two years of receipt. There would be no need to make any payment for the profits interest. Thus, formation of an LLC together with the grant of profits interests to the key employees would meet all of the goals that Paul and Kim have identified.

Revenue Procedure 2001-43 extends this “no-tax” result to a nonvested profit interest. Because Revenue Procedure 93-27 concedes that no adverse tax consequences arise when a partnership profits interest is transferred to a service provider, an LLC appears to be the obvious choice for Paul and Kim. However, it is possible to replicate the rewards of a partnership profits interest in a corporate form with similar tax and economic consequences to the service provider. When proposed regulations issued on May 24, 2005, are issued in final form, these two revenue procedures will become obsolete.

A corporation could also be used to provide the “profits only” compensation that Paul and Kim want for their key employees.

If Paul and Kim also want to consider a corporate form, the key employees could be rewarded in one of two ways:

1. Paul and Kim could grant the employees options to acquire stock in the new corporation. The option price would be set at the fair market value of the stock on the date of grant. Thus, the employees would profit only if the value of the company increased. Also, the employees would not be required to pay anything to acquire the option—their only payment would occur when they exercised the options, which they can do at their discretion (after the value of the stock has increased). The employees would not be taxed on receipt of the options because the options would not have a readily ascertainable fair market value. The §83 regulations provide that the employees will not be taxed until they exercise the options and acquire the stock. When the employees exercise the options, they must pay the date-of-grant fair market value so that their reward, and the amount that they will include in taxable income, is limited to the increase in value after the date of grant. To make the determination of value easier, the plan may define fair market value to be book value or some multiple of earnings.[104]

2. This will avoid the need for a costly appraisal of the business and will reward the employees in a manner similar to the partnership profits interest.

   The employees could be granted stock appreciation rights, also called SARs. A SAR pays the employee, usually in cash, the difference between the fair market value of the company’s stock at the payment date and the fair market value at the date the right is granted. Thus, the employee benefits only to the extent that the company’s stock value increases. Once again, fair market value may be defined in the plan by reference to book value or some multiple of earnings. The employee is not taxed until the SAR right is exercised and payment is received. The employee is not in constructive receipt of

[104] See Reg. §1.83-5(a) for support for using book value to determine fair market value in nonqualified stock-based compensation plans.

compensation before that date because to exercise the right would mean that the potential for additional profits would be forfeited.[105]

Both stock options and SARs may be used in S corporations without risking a prohibited second class of stock.[106] However, such arrangements must be tested under the Section 409A deferred compensation rules.[107]

The corporation will receive a deduction at the same time and in the same amount of compensation reported by the employees. If a stock option or a SAR is used, the employees will report compensation income subject to payroll taxes (employer and employee). The corporation will receive a deduction for the compensation. If the nature of the services provided would require capitalization under general tax principles, the entity's deduction is allowed only using normal cost recovery or amortization rules.

If a profits interest in an LLC is used, there is a strong likelihood that the LLC will not receive a deduction for the profits-interest distributive-share amounts. If the profits interests are not taxable on receipt, the key employees should be recognized as members of the LLC. As a result, the key employees will report their distributive share of LLC profits as the profits are earned. The key employees will receive a schedule K-1 and will report the income, retaining the character (ordinary, capital, and so on) as determined at the LLC level.

If the key employees report their profits share as distributive-share items, the LLC will not be entitled to a deduction. That is, neither of the parties will report the items as compensation. The payments cannot be deductible §707(c) guaranteed payments because they are determined (solely, in fact) by reference to the income of the LLC. Note that the Rev. Proc. 93-27 safe harbor for profits interests applies only when the interest is received in the capacity as a partner. Final regulations, when issued, will retain this requirement.

The receipt of profits when a stock option is exercised or a SAR is exercised will result in ordinary compensation income to the employee (subject to payroll taxes) and an offsetting deduction to the employer. Because the LLC profits interests are not taxed at the date of receipt, the employees will probably report all profits as distributive-share items and not as compensation. Similarly, the LLC will not be entitled to a compensation deduction for the employees' distributive shares. No payroll taxes will be owed, although the employees may be subject to self-employment tax if they are member-managers.

It is probably easier to meet the compensation objectives of Paul and Kim by using the LLC form because the IRS has clearly stated its views on the tax treatment of profits interest, and the key employees are more likely to understand what they are receiving if they get a profits interests in an LLC.

Both stock options and SARs would need to be defined as to fair market value, presumably by reference to book value. The key employees will probably have a more difficult time understanding the basis on which they will be rewarded if an option or SAR is used. Also, very

[105] Revenue Ruling 80-300, 1980-2 CB 165.
[106] See Reg. §1.1361-1(1)(4)(iii)(B) for the statement that compensatory options are not a second class of stock. There are several letter rulings that support SARs not being a second class of stock. For example, see Letter Ruling 9011055.
[107] Prop. Reg. Section 1.409A-1(b)(5).

few employees understand the economic aspects of options. Thus, the primary recommendation should be that Paul and Kim form an LLC and grant profits interests to the key employees. However, if they prefer the S corporation form for other reasons, they should understand that the compensation goals may be met in a corporate form.

Chapter 4

Distributions

Overview

We discussed in Chapter 3 the basics of how the operations of the business entity are taxed. The particular entity chosen also has tax implications related to moving those profits out of the entity and into the hands of the owner. Even entities that are designed as flow-through entities, so that their income is only taxed once at the owner level, may face an owner-level tax on distributions depending on the level of basis and other factors.

A distribution of profits may consist of either money or property. Each of the aforementioned entities may engender varying degrees of tax exposure when profits are distributed in the form of property. The taxability of distributions, of course, will typically depend on the amount of basis the owner has in his or her interest in the case of a flow-through entity. Distributions of property, if other than cash, may create additional issues that will be discussed in more detail in this chapter. An entity may also distribute property in such a way that it will not be deemed a distribution of profits but is instead treated as a return of capital.

The focus of this chapter is on how the tax laws treat an entity and its owners when the entity distributes money or other property to its owners. First, the chapter will review and compare the basic rules affecting distributions from each of the primary entity types. The case studies will then devote additional attention to how the entities differ and why one type of entity may be superior to another with respect to distributions.

One item should be emphasized prior to maneuvering through the detailed rules of the various entities. If the owners of the business desire to be able to make distributions that are not proportionate to ownership (and these cannot be accomplished through salary, rentals, guaranteed payments, and so on) a partnership or LLC taxed as a partnership will likely be required to accomplish this objective. Distributions from an S corporation must be proportionate based on ownership of stock and there can be only one class of stock. If disproportionate distributions are made from an S corporation, the Service will consider this a second class of stock and the S election will be subject to termination. This is one of the two key advantages of an FLP (family limited partnership) over a family S corporation.[108]

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[108] The other is the possibility to use a §754 election. Also, disproportionate distributions when taken to an extreme case may cause problems even in the FLP world. These topics are discussed in greater detail in Chapter 6.

C Corporation Distributions

Double Taxation

A C corporation will have double taxation if it distributes profits as a dividend. In other words the corporation will pay tax on its profits at the corporate level. In addition, when shareholders receive dividends of earnings and profits, these amounts are also taxed at the owner level. A corporate shareholder is allowed a dividends-received deduction in order to prevent complete triple taxation.

A dividend is a defined term for tax purposes and does not apply to all distributions made by C corporations. For example, if certain qualifications are met, a distribution may be structured as a redemption and receive capital gains treatment.

Dividends

Section 316 defines a dividend to be a distribution of property by a corporation to its shareholders if the distribution is made from current or accumulated earnings and profits. Property is defined in §317 to be money or any other type of property other than stock in the distributing corporation. Thus, a dividend can consist of money, equipment, land, improved real estate, inventory, or any other type of asset held by the corporation other than stock of the distributing corporation.

Earnings and profits refer to the corporation's economic ability to pay a dividend. Distributions from earnings and profits are treated as a return on capital and are subject to a second level of tax. Distributions not from earnings and profits are treated as a distribution of capital and are tax-free to the extent of the shareholder's basis in her stock. Revenue Procedure 75-17 states that earnings and profits begin with taxable income for a particular year. Section 312 explains what adjustments to make to taxable income to reach earnings and profits.

Probably the easiest way to think about earnings and profits is in this way. In order to make a cash dividend for financial accounting purposes, a corporation must have both cash and retained earnings. For tax purposes, a similar idea exists in which the corporation would need to have both cash and earnings and profits. However, this should not be taken to mean that earnings and profits are calculated in the same manner as retained earnings. On the contrary, they are calculated based on the adjustments described above and reflect Congress's idea of the economic income of the corporation rather than GAAP's idea.

Section 301(c) provides that the tax treatment of a distribution of property from a corporation to its shareholders shall be

1. First, a dividend to the extent that the distribution is made from either current year earnings and profits or earnings and profits accumulated from prior years.
2. Second, a return of capital, reducing the shareholder's basis in her shares, provided that the basis of the shares may not be reduced below zero.
3. Third, as an exchange transaction in which the shareholder receives the property in exchange for stock in the distributing corporation. This step will generally result in

capital gain treatment to the shareholder because corporate stock is almost always held as a capital asset.

Avoiding Two Levels of Tax

The corporate tax may be eliminated by distributing all earnings to the shareholders in a way that will allow a corporate-level deduction. This has created an incentive for some taxpayers to be overly generous to themselves in terms of payments. The IRS and Congress know this and have created hurdles to deducting certain payments to shareholders. In addition, some taxpayers go so far as to treat their corporations as a personal checkbook and make payments for items that are clearly not items properly deductible by the corporation unless they are treated as either compensation or a dividend to the owner. Such payments, if not treated properly, constitute inappropriate tax evasion and should not be condoned.

A C corporation may also distribute profits in some form other than as a dividend. In closely held corporations, one of the principal tax planning objectives is to distribute corporate earnings in a legitimate manner that will not trigger two levels of tax. There are three primary ways to distribute C corporation profits with only one level of tax.[109] Each method permits the corporation to claim a deduction for the amount of the distribution, if reasonable, thereby eliminating the corporate level of tax. The shareholder is taxed on the distribution, but the corporate-level deduction results in only one level of tax.

The three primary methods to reduce the C corporation tax burden are

1. A payment to the shareholder for use of his or her services (compensation).
2. A payment to the shareholder for use of his or her money (interest).
3. A payment to the shareholder for use of his or her property (rent or royalty).

Each of the three methods listed above is subject to statutory restriction. Section 162(a)(1) allows a deduction for compensation only if the compensatory payment both is for services and is reasonable for the services provided. Reasonable compensation is a facts-and-circumstances determination. Tax services are filled with cases in which the IRS and taxpayers have produced dueling experts regarding whether compensation is being made at the proper level. In the C corporation world, the Service has traditionally had the incentive to show that salary is too high. It is best for the taxpayer if the corporate minutes show how the owner-employees' proper salary is set.

Deductions for rent payments are similarly limited by §162(a)(3) to those amounts that are reasonable for use of the property in question. Once again, the reasonableness of rent is a facts-and-circumstances determination.

[109] As discussed in the last chapter, one of the best means of lowering the tax burden is through the use of a good qualified retirement planning system. This allows a deduction at the corporate level and defers the tax at the individual level until the owner retires. The downside of this type of qualified plan to some owners is that non-discrimination rules apply and require coverage of non-owner employees. Other types of deferred compensation may also be available. However, these will typically be subject to the onerous provisions of §409A and should only be developed in consultation with an expert in deferred compensation matters.

Interest deductions may be limited in two ways. The most common limitation is that a deduction is allowed only if the interest payment is made on account of a bona fide indebtedness. In closely held corporations, the status of a debt instrument may be questioned as disguised equity. If the corporation is thinly capitalized, the shareholder's classification of an investment as debt may not be determinative for tax purposes. Section 385 provides statutory authority for classifying purported debt instruments as equity.

To those practitioners who have been around for a while, the §385 regulations project is one of the most notable failures to generate regulations. This represents one of those items that is properly referred to as "funny-sad" rather than "funny-humorous." Although in fairness to the Service, the ability of financial specialists to create hybrid instruments around whatever standard the Service puts into a regulation makes it understandable to avoid specific standards in a regulation and simply to litigate based on the facts under the more conceptual statutory authority.

Interest payments may also be limited if the amount is excessively high. This attack is rarely seen, but the IRS has authority to recharacterize payments of interest that exceed a reasonable amount.

Significant planning opportunities exist in C corporations to enable owners to withdraw profits as deductible compensation, interest, or rents. The practitioner should carefully document the nature of payments to support the deductibility in the event of an administrative challenge. It is best to document the reasonableness of such payments when they are first structured, not when the IRS later challenges them.

C Corporations also have the opportunity to make payments on behalf of owners that result in zero levels of tax. If the corporation provides a nontaxable fringe benefit (see §§101-137 inclusive and §79) to the owner of the business, it generally receives a deduction for the cost of the benefit but the shareholder need not include the benefit in income. Thus, the profits used to purchase the fringe benefit are not taxed. The general limitations on the use of fringes are as follows:

- Many fringes must be offered to all employees on a nondiscriminatory basis. This requirement entails costs of covering employees other than the shareholders as well as compliance costs.

- Fringes are available only to employees. Thus, the shareholder must also be employed by the corporation. Also, the deductibility of fringes is subject to the overall limit on the reasonableness of compensation paid to the shareholder-employee.

Other C Corporation Issues

If a C corporation can accumulate profits without making dividend distributions, the shareholder-level tax is deferred until the shares are sold or until the corporation is liquidated. If this can be accomplished until the shareholder passes shares to his or her heirs, the step-up in basis for the stock may result in no income tax effectively being paid on appreciation prior to the date of death. (This will be discussed in more detail in Chapter 6.) Also, a liquidation of the entity or a sale of the shares may be so far off in the future that the present value of the capital gains tax is insignificant.

The 2003 Tax Act lowered the maximum tax rate for "qualified" dividends to 15 percent (0 percent for taxpayers in the 10 percent or 15 percent brackets for ordinary income purposes). This preferential rate is currently set to expire after 2012. Practitioners should discuss this uncertainty with their clients. With the low dividend rate, a C corporation and its shareholders may now prefer to distribute earnings as dividends, at least for relatively low levels of earnings.[110]

As an example, assume a closely held C corporation has $50,000 of earnings. Those earnings could be distributed in one of two ways:

1. *A salary to the shareholder-employee*—This option avoids any corporate tax but the shareholder must pay income tax. Also, both the corporation and the shareholder must pay payroll tax.
2. *A dividend to the shareholder*—The corporation must pay a $7,500 tax (15 percent) on $50,000 of taxable income. The shareholder receives a $42,500 dividend and pays a 15 percent tax, or $6,375. The total tax is $13,875, or 27.75 percent of available earnings.

If we assume a high tax bracket shareholder-employee, the dividend option may actually result in lower taxes when the corporation is in a low tax bracket and the effect of payroll taxes is considered.

Distributions by S Corporations

Overview

The tax treatment of distributions from an S corporation to its shareholders is generally straightforward. This is particularly true as long as the entity has been consistently profitable and has never been a C corporation. Difficulties arise when the S corporation has earnings and profits. Before considering these difficulties, it is first worth mentioning that an S corporation will not generate earnings and profits in any S years. The reason is simple: earnings and profits exist solely to determine the applicability of a dividend tax result to the shareholder (which creates the second level of tax in a C corporation). Thus, earnings and profits is a concept that has no place in an S corporation because distributions of S corporation earnings, having already been taxed to the shareholder, are not dividends.

A problem arises when the S corporation has earnings and profits from a prior year as a C corporation. Distributions must then be based on an ordering that involves both earnings attributable to the C years and those attributable to the S years. If the S Corporation has no earnings and profits, which will be the case for an S that was never a C or that, while it was a C, never generated earnings and profits, there is no need to distinguish distributions attributable to earnings from a C corporation year and those earnings attributable to S years.

Because S earnings flow through and are taxed in the year they are earned by the entity, distributions from an S corporation with no C earnings and profits will be nontaxable to the

[110] The preferential rates on long-term capital gains and qualifying dividends have been extended through 2012 by tax relief legislation passed in late 2010. The top ordinary rate for individuals remains at 35 percent through 2012 as well. If Congress does not act to further extend these rates the long-term capital gains rate will return to 20 percent and the ordinary maximum rate will return to 39.6 percent.

extent of the shareholder's basis in her stock. Any distribution in excess of stock basis will be treated as a capital gain from the sale of stock.

The above discussion assumes that the distribution is made with respect to the shareholder's stock. If the transfer is instead a repayment of a debt obligation owed by the corporation to the shareholder, the transfer is an exchange of the debt instrument for cash.

Distributions When the S Corporation Has Earnings and Profits

When the S corporation has earnings and profits, the tax treatment is determined by reference to which layer the distribution comes from. A corporate-level account, referred to as the accumulated adjustments account (AAA), is maintained to (generally) measure the earnings related to taxable items of the S corporation in S years. This account exists to distinguish S earnings (AAA) from C earnings (earnings and profits). Distributions attributable to S earnings (that is, from the AAA) are generally tax-free because the earnings have already been taxed. Distributions from C earnings (that is, from earnings and profits) are taxed as dividends to the shareholder.

Formally, distributions from an S corporation with earnings and profits are taxed in the following manner:[111]

1. First, a nontaxable return of capital to the extent of the AAA. (**Note.** Distributions from AAA reduce the shareholder's basis.)
2. Second, if the AAA distributions reduce the shareholder's stock basis to zero, any further distributions from AAA are taxed as capital gains. That is, until AAA is exhausted, no portion of a distribution may be a dividend. However, distributions in excess of basis must be taxed, so they are taxed as capital gains.[112]
3. Third, after the AAA is reduced to zero, a dividend to the extent of accumulated earnings and profits.[113]
4. Fourth, to the extent of basis remaining after the application of step 1, a nontaxable return of capital.[114]
5. Fifth, any excess is an amount received in exchange for stock, generally resulting in capital gain.

The AAA is a corporate level account that records post-1982 S earnings that have not been distributed (that is, taxed to the shareholders, but not yet distributed). Generally, the account is needed only for S corporations with earnings and profits because other S corporations do not

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[111] Section 1368(c).
[112] This level is not typically a problem as the shareholder's basis will usually be larger than his or her portion of AAA. If this were to occur, information sharing would be necessary between the owner and the corporation. The AAA account is a corporate level account, while basis is a shareholder level item.
[113] It should be noted that this type of distribution of earnings and profits is a 1099-Div event for reporting purposes rather than simply a K-1 reporting item.
[114] Technically this level of basis is also in two stages. First, there is OAA, which contains the tax-exempt income and related non-deductible expenditures. Second, there is other basis, which is typically the owner's initial investment in the corporation along with any additional contributions to capital.

need to distinguish distributions from S earnings and those from C earnings.[115] However, if the S corporation later terminates its election and becomes a C corporation, knowledge of the AAA balance is essential to make nontaxable (monetary) distributions of undistributed S earnings during the post-termination transition period. Thus, all S corporations should track the AAA.

The existence of Subchapter C earnings and profits may also subject an S Corporation to the Section 1375 penalty tax on excess passive earnings. If this tax is assessed for three consecutive years, the S election is lost effective as of the first day of the fourth tax year.

One way to avoid the excess passive income tax, including loss of the S election, is to distribute all subchapter C earnings and profits. All affected shareholders may elect to make distributions from such earnings. Given the current preferential rates of tax on dividends, this may be the time to engage in distributions of earnings and profits trapped in S corporations. The election is made pursuant to Regulation §1.1368-1. If PTI exists, a second election must be made to bypass the PTI as well as the AAA.

The 15 percent (0 percent for low-income taxpayers) tax rate applicable to post-2002 qualified dividends may make the election to distribute subchapter C earnings more attractive, particularly for an S corporation at risk of exposure to the excess passive income tax.

Distributions from an S Corporation Without Earnings and Profits

A corporation that has always been an S corporation throughout its life will generally have no earnings and profits. If there are no C corporation earnings that may be subject to two levels of tax, that is, if there are no earnings and profits, distributions from an S corporation will be taxed in the following order:[116]

1. The distribution will be tax-free to the extent of the shareholder's stock basis.
2. Any distribution in excess of a shareholder's stock basis will be treated as a payment in exchange for the stock, generally resulting in a capital gain.

Because distributions from S corporations without earnings and profits are generally tax-free, it is tempting to avoid compensating shareholder-employees for the full value of their services. That is, the corporate deduction for salary payments is often of no value in S corporations (unless compensation is disproportionate to stock ownership) because there is only one level of tax whether payments are made as salary or as distributions.

As discussed in Chapter 3, in order to avoid or minimize payroll taxes imposed on compensatory payments, many S corporations reduce salary payments in exchange for larger distributions. The IRS is wary of this strategy and has won several cases where taxpayers paid no compensation.

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[115] It is also possible that the S corporation may also need to track PTI. PTI is previously taxed income that has flowed through from an S corporation prior to 1983. If so, this represents additional amounts that may be distributed without additional taxation. Unlike AAA, which is a corporate level account and remains if a shareholder's interest is transferred, PTI is assigned to the shareholder specifically while being tracked and reported by the S corporation.
[116] Section 1368(b).

The Tax Effects of Distributions on the Corporation

If a corporation distributes money, the corporation does not recognize a gain or loss. If the distributing entity is a C corporation, earnings and profits will be reduced (whether or not the distribution is a dividend to the shareholder).[117] If property is distributed by a C corporation, earnings and profits are reduced, but not below zero, by

- The adjusted basis of the property, if the value of the property does not exceed its basis; or
- The fair market value of the property, if that value exceeds its adjusted basis.[118]

Distributions of appreciated property are treated as a taxable sale by the corporation (be it a C corporation or an S corporation). A C corporation will be taxed on this sale; an S corporation generally will pay no tax, but the gain from the deemed sale will flow through to the shareholders and will increase their taxable incomes. This represents the difficulty associated with putting appreciated property into the corporate form as discussed throughout this book.

Specifically, §311(b) states that if a corporation distributes property with a fair market value in excess of its basis, the distributing corporation must recognize gain as if the property were sold to the shareholder at fair market value. This gain will increase taxable income and will, therefore, increase earnings and profits.[119] Section 311(a) does not allow recognition of a loss if the distributed property has an adjusted basis in excess of its fair market value.[120]

The AAA of an S corporation will be reduced, but not below zero, by the amount of the distribution.[121] The amount of the distribution is either the amount of money distributed or the fair market value, net of liabilities, of any property distributed. If an S corporation distribution is from earnings and profits, the balance in earnings and profits is reduced as discussed above.

Section 311, providing for recognition of gains but not losses on distributions of property to shareholders, applies to S corporations. If the S Corporation distributes appreciated property to its shareholders, the S Corporation will have a recognized gain that must be reported on the Form 1120S and will typically flow-through to the owners and be taxed at the shareholder level. Note, however, that when a C corporation converts to an S corporation, a built-in-gains tax may apply to certain S corporation gains realized within the first ten years after the conversion. If the built-in-gains tax applies to the corporation, the S corporation will pay tax on the recognized gain. The amount of the distribution to the shareholder will then be reduced by the corporate-level tax imposed by §1374.[122]

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[117] Section 312(a)(1).
[118] Section 312(a)(3) and (b)(2).
[119] Section 312(b)(1).
[120] This rule does not apply to certain distributions in liquidation of the corporation.
[121] Section 1368(b) and (c).
[122] Section 1366(f)(2).

Partnership Distributions

Overview

It does not take long in practice to realize that partnerships are one of the most complex areas of the tax law. The desire to provide flexibility in structure to meet the economic needs of the partners has resulted in the potential to use the partnership form to accomplish unintended tax avoidance transactions. In response to perceived abuses, Congress has made partnership distributions much more complicated. This increased complexity reduces any compliance advantage that partnerships may have had over other forms of an entity with respect to the treatment of distributions.

The tax treatment of partnership distributions generally follows an aggregate rather than an entity approach, which results in no immediate tax effect to the distributee partner or to the partnership. A partner recognizes gain only when he receives an amount of money in excess of the basis of his partnership interest.[123]

A partner may recognize gain or loss from certain partnership distributions when the basis rules of §732 prescribe such a result. Generally, the basis of property distributed from a partnership will carry over to the distributee partner.[124] However, when a distribution is in liquidation of a partner's interest, the basis of the liquidated interest is generally substituted for the basis of distributed assets.[125] This could result in an increase or decrease in the basis of certain distributed assets. This difference is due to the fact that at liquidation, all of the partners outside basis in his or her interest must be used. Since there is no partnership interest remaining in a liquidation, there can be no basis left on this interest.

Two special rules may require that a partner recognize gain or loss from a distribution. *First*, the basis of a partnership interest (outside basis) can never be negative, and the basis of money can never be less than its face amount. Money, therefore, will always acquire a carryover basis from the partnership and the basis of a partnership interest must first be reduced by the amount of any money distributed.[126]

If the money distributed exceeds the basis of the interest immediately before the distribution, the partner recognizes gain and the basis of the interest in the partnership becomes zero. This gain is treated as if a sale or exchange of the partnership interest had occurred, and the character of the income is determined accordingly.[127] A reduction in a partner's share of partnership liabilities,

[123] Section 731(a)(1).
[124] Section 732(a)(1).
[125] Section 732(b).
[126] Section 733(1).
[127] In Revenue Ruling 95-5, 1995-1 CB 100, the IRS ruled that income from a cash distribution in excess of basis may be passive where the distributee's share of income from one or more activities of the partnership is passive. The deemed disposition of the partnership interest will require an allocation of the income among all activities of the partnership that would produce net gain if they were sold at fair market value on the applicable valuation date. See Reg. §1.469-2T(e)(3)(ii)(A) for the determination of passive income or loss when an interest in a partnership is sold.

which is treated as a distribution of money under §752(b), may also require that a partner recognize gain.[128]

Second, ordinary income assets (also referred to as hot assets) may not have basis allocated to them in excess of the basis of such assets to the partnership.[129] This is true for both operating and liquidating distributions. Ordinary income assets include the following:

- Partnership unrealized receivables [see §751(c)]
- Partnership inventory items [see §751(d)(2)]

The term *unrealized receivables* includes a wide-variety of assets with ordinary income potential. For example, assets with depreciation recapture potential are classified as unrealized receivables to the extent of the recapture potential.[130]

The reason the allocation of basis to ordinary income assets is limited is straightforward: to prevent the distributee partner from reducing his allocable share of ordinary income from the partnership by increasing the basis of ordinary income property. The practical effect of this rule is to prevent the taxpayer from converting ordinary income into capital gain, or converting capital loss to ordinary loss by shifting basis to ordinary-income-type property.

If the only property distributed in liquidation of a partner's interest is money and ordinary income property, the restriction on the amount of basis which may be assigned to such assets can result in the recognition of a loss by the distributee partner. This occurs when the basis of the distributee's interest exceeds the sum of the amount of money distributed plus the carryover basis of the ordinary income property distributed in liquidation of the partner's interest. If property other than money and ordinary income property is distributed, no loss results because any remaining basis is allocated to the non-ordinary income asset(s). Since the partnership interest is eliminated in a liquidating distribution, all outside basis must be assigned somewhere. It then follows that if only carryover of outside to inside basis can occur for cash and hot assets, then any remaining basis must be allowed as a capital loss in order to prevent the disappearance of basis without a tax effect. To see an example of this situation, please refer to Example 4-1 on the following page.

Disproportionate Distributions of Section 751 Assets

Section 751 is designed to ensure that each partner reports his proportionate share of ordinary income items of the partnership. If one partner receives a distribution that does not represent his proportionate share of such assets, §751 recharacterizes the distribution as a proportionate one followed by a sale of certain assets (those not received) and a purchase of others (the extra share received). This characterization creates tax consequences for both the distributee and the

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[128] In Revenue Ruling 94-4, 1994-1 CB 195, the IRS ruled that the deemed distribution may be treated as a partnership draw, allowing the partner experiencing the reduction in liability share to determine the tax treatment as of the last day of the partnership's tax year pursuant to Reg. §1.731-1(a)(1)(ii). The draw may then be tax-free if there is sufficient income allocated to the partner during the year.
[129] Section 732(c)(1).
[130] Section 751(b).

partnership. Case 4-3 provides a detailed calculation of the tax impacts of §751 upon a disproportionate distribution of assets.[131]

Example 4-1

In liquidation of his interest in a partnership, which has an outside basis of $12,000, Jeff receives $3,000 of cash and inventory with a fair market value of $20,000 and an inside basis to the partnership of $1,000. First, $3,000 of basis is allocated to the cash and then $1,000 to the inventory, leaving $8,000 of basis to account for. Since the interest is liquidated, no basis may remain with it, and a loss of $8,000 will be recognized. The capital loss is allowed to prevent Jeff from increasing the basis of the inventory to $9,000, which would reduce the amount of ordinary income to be reported when the inventory is sold. Thus, the loss occurs because the drafters of the statute were concerned with preserving the ordinary income potential associated with the inventory.[*]

[*] Note that §735 provides that the distributee recognize ordinary income or loss if partnership inventory is disposed of within five years of the date of distribution. This prevents a conversion of the character of income by a partner who does not hold distributed property primarily for sale.

Disguised Sale Provisions

The rules related to the contribution of property to partnerships in exchange for an interest have the potential for abuse if partners are allowed to effectively cash out of the property that has been contributed to the entity. For this reason, §707(a)(2)(B) states that if there is a direct or indirect transfer of money or other property to a partnership, and there is a related direct or indirect distribution of money or other property to the contributing partner, and the two transactions when viewed together are properly characterized as a sale or exchange of the property, then the transfers will be treated consistent with their substance. This means that if a distribution is part of a disguised sale, it is not a distribution but instead represents proceeds from a sale or exchange. To the extent that a disguised sale exists, any §704(c) allocations made with respect to contributed property should be reversed.[132]

A disguised sale requires two conditions:[133]

1. Interdependence of the contribution and distribution, and
2. Absence of entrepreneurial risk for the distribution proceeds.

If a transfer of property to a partnership occurs within two years of the date of a distribution to the contributing partner, without regard to the order of the two transactions, there is a presumption that a sale has occurred.[134] Further, there is a presumption that if such transfers are

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[131] Note that payments to retiring partners may also be subject to §736, which works to characterize payments to these partners that are not considered as being in exchange for property (unrealized receivables and goodwill if not provided for in the partnership agreement) into ordinary income.
[132] Section 704(c) requires that allocations made with respect to contributed property must take into account the difference, if any, between the fair market value and the tax basis of the property at the date of contribution. If a partner contributes property to the partnership in one year and a distribution made in a subsequent year causes the earlier contribution to be recast as a sale, then any §704(c) allocations made in the earlier year must be amended.
[133] Regs. §1.707-3(b)(1).
[134] Reg. §1.707-3(c).

not within two years that no sale has occurred.[135] When the distribution is more than six months after the contribution,[136] but still within the two-year presumption, the disguised sale may also be a deferred payment sale in which interest must be imputed.[137]

Early Trigger of Section 704(c) Gain

When property is contributed with a fair market value different from its tax basis, allocations with respect to that property must be made using §704(c) principles. This is to prevent the partnership rules from being used to shift the pre-contribution gain on property to other owners. Sections 704(c)(1)(B) and 737 may accelerate the effects of §704(c) for certain distributions made within seven years of the contribution. Neither C corporations nor S corporations face the equivalent of these provisions.

Example 4-2

Bob and Sandy form an LLC as equal co-owners. Bob contributes a piece of land with a $50 basis and a $100 fair market value while Sandy contributes $100 cash. If the LLC sells the land (a capital asset to both the partner and the entity) the following day (and there is not any change in its value) the $50 of tax gain is all allocated to Bob. This will then equalize the outside bases of the partners (each will have $100) and match their capital account balances. If the partnership is liquidated the next day, each partner would receive $100 back and there would be no gain on the liquidation.

Contrast this with an S corporation. If Bob and Sandy perform the same transaction in exchange for S corporation stock and the S corporation sells the land the next day, each shareholder will have flow-through capital gain of $25. Each shareholder's basis in his stock will increase by $25 so that Bob's basis in his stock is $75 and Sandy's is $125. If the S corporation liquidates the next day there will be no tax flowing through the corporation since its only remaining asset is cash and there is therefore no appreciation. The distributions would be according to stock ownership so each would receive $100 as in the partnership case. However, each shareholder would face a different tax consequence upon the distribution. Bob would have a $25 gain ($100 – 75) while Sandy would have a $25 loss ($100 – 125).

Of course in this simple example in which all the transactions occur within the same tax year, the net effect of both cases is the same. Bob has a total of $50 in gain while Sandy has no gain or loss when all the effects are netted together. However, now picture a case in which it is decades before the entity is liquidated or before distributions exceed the flow-through income of the entity. In these cases, the S corporation provides an interesting ability to shift income for a time to other business owners although it will equal out upon dissolution of the entity.

[135] Reg. §1.707-3(d).
[136] Section 1274(c)(1)(B) applies when some or all of the payments are due more than 6 months after a sale or exchange.
[137] See Reg. §1.707-3(f), *Example 2*, for an illustration of this rule.

Section 704(c) requires that allocations made with respect to contributed property take into consideration the difference, if any, between the fair market value and tax basis of the property at the time it is contributed. Section 704(c)(1)(B) and §737 are designed to prevent avoidance of the mandatory §704(c) allocation rule.

Both provisions apply only to §704(c) gain attributable to property contributed after October 3, 1989, and only with respect to distributions occurring after a certain date, which is different for each provision. Also, a distribution must be within seven years of the contribution of the §704(c) property although, under limited anti-abuse rules, the provisions may also apply to certain distributions that are more than seven years after the date of contribution.[138]

Section 704(c)(1)(B) requires the contributing partner to recognize any remaining §704(c) gain or loss when contributed property is distributed to a partner other than the contributing partner within seven years of the contribution.[139] The amount of §704(c) gain or loss is determined as if the property had been sold to the distributee partner at fair market value, with the resulting gain or loss allocated using §704(c) principles.[140]

Example 4-3

Partner Alex contributes property with a fair market value of $40,000 and a tax basis of $20,000 to the AB partnership. The property is depreciated on a straight-line basis over five years. Within the first three years of operations, the partnership reports book depreciation of $24,000 and tax depreciation of $12,000. The book depreciation is shared equally by the two partners and the tax depreciation is allocated entirely to the noncontributing partner, as is appropriate under §704(c). The depreciation allocation reduces the §704(c) gain from $20,000 to $8,000 by the end of the third year. At that time, Alex's contributed property is distributed to the other partner. The fair market value of the property is $23,000 at the time of the distribution. If the property were sold for $23,000, the partnership would report a taxable gain of $15,000 ($23,000 minus $8,000 adjusted tax basis) and the first $8,000 of that gain would be allocated to Alex pursuant to §704(c). Section 704(c)(1)(B) will then require Alex to report an $8,000 taxable gain when the property is distributed.

The character of §704(c)(1)(B) gain or loss is determined as if the property were sold to the distributee partner.[141] If the distributee controls the partnership, §§707(b)(2) or 1239 may characterize the gain as ordinary income.[142]

Both the contributing partner's basis in his partnership interest and the partnership's basis in the property distributed to the noncontributing partner are increased (or decreased) for any §704(c) gain (or loss) recognized.[143] The basis adjustment to the contributing partner may affect his or her gain or loss from a distribution of money as part of the same transaction, or basis in other

[138] See Reg. §1.704-4(f), *Example 1*, for such an abusive situation.
[139] Regs. §1.704-4(c) illustrates several distributions that will not trigger gain, including deemed distributions under §708(b)(1)(B) terminations, transfers to another partnership, and incorporation of a partnership.
[140] Section 704(c)(1)(B)(i).
[141] Section 704(c)(1)(B)(ii).
[142] See Reg. §1.704-4(b)(2), Example.
[143] Reg. §1.704-4(e).

property distributed as part of the same transaction. The adjustment to the partnership's basis in the distributed asset occurs immediately before the distribution and may affect the distributee partner's basis in that property under the rules of §732.

Section 737 applies when a partner who contributed §704(c) property receives a distribution of property other than the contributed asset within seven years of the date of contribution.[144] In such a case, the contributing partner recognizes gain equal to the lesser of[145]

- The excess distribution, or
- The net precontribution gain.

The excess distribution is the excess of the fair market value of the distributed property over the partner's basis in his partnership interest.[146] The fair market value of property distributed subject to a liability is not adjusted for the liability. However, the basis of the partner's interest is adjusted, using §752 principles, for the liability assumption.[147]

Example 4-4

Laura acquires a one-third interest in the LMR partnership by contribution of property with a fair market value of $50,000 and a tax basis of $20,000. When Laura's §704(c) gain is still $30,000, and within seven years of her original contribution, Laura receives a distribution of land, which was not contributed by Laura, with a fair market value of $40,000 that is subject to a liability of $12,000. Laura's basis in her partnership interest, determined immediately before the distribution is $24,000, which amount is the sum of the basis of her contributed asset and one-third of the partnership's liability on the land. The excess distribution is determined as follows: the fair market value of the land is $40,000 and the basis of Laura's interest is $32,000, determined by adding the incremental $8,000 liability assumption ($12,000 total minus Laura's $4,000 predistribution share) to the $24,000 basis determined in the preceding sentence. The excess distribution is then $8,000. Because Laura's net precontribution gain is $30,000, she must recognize $8,000 of §704(c) gain when the land is distributed.

Gain recognized under §737 has the same character as the partner's precontribution gain with respect to the contributed asset, computed as if that asset had been sold to an unrelated party in an arm's-length transaction.[148] In contrast, §704(c)(1)(B) determines the character as if the asset were sold to the distributee partner. If the distributee partner is a related party with respect to the partnership, §§707 or 1239 may require §704(c)(1)(B) gain that would otherwise be capital or §1231 to be ordinary income. The distinction between the two provisions arises because §704(c)(1)(B) involves a distribution of the contributed asset to another partner, facilitating its treatment as a deemed sale, whereas §737 does not involve the distribution of the contributed asset at all, requiring reference to what the character would have been at the time of contribution.

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[144] See Reg. §1.737-2 for examples of distributions that will not trigger §737, including transfers to another partnership, incorporation of the partnership, and deemed distributions under §708(b)(1)(B).
[145] Section 737(a).
[146] Section 737(a)(1).
[147] Reg. §1.737-1(e), *Example 2*.
[148] Regs. §1.737-1(d).

Section 737 gain increases the contributing partner's basis in the partnership interest and also increases the partnership's basis in the contributed §704(c) property retained by the partnership.[149] These basis adjustments are not elective and do not rely on the existence of a §754 election.

Marketable Securities as Cash

Effective for distributions occurring after December 8, 1994, the term "money" for purposes of §731(a)(1) includes the fair market value of marketable securities distributed to a partner.[150] This rule does not, however, apply for purposes of §731(a)(2), which allows a loss to be recognized from certain liquidating distributions. Thus, the receipt of any marketable securities in a liquidating distribution will prevent a partner from recognizing a loss. However, a partner who receives a distribution of marketable securities with a fair market value in excess of the basis of his partnership interest will be required to recognize gain and the basis of such marketable securities will be the basis as determined under §732 increased by any gain recognized in the distribution.[151]

The following example compares the tax treatment of a distribution of marketable securities occurring before December 9, 1994, using the rules previously described in this section, with that of a distribution occurring after December 08, 1994.

Example 4-5

Jeff's basis in the XYZ Partnership is $20,000. In liquidation of his interest, Jeff receives a distribution of marketable securities with a fair market value of $30,000 and a tax basis to XYZ of $30,000. The distributed securities were not contributed to the partnership by Jeff. If the distribution occurred before December 9, 1994, Jeff would recognize no gain because he did not receive a distribution of money in excess of the basis of his partnership interest and the marketable securities would have a basis of $20,000 to Jeff.[*] If the distribution occurs after December 8, 1994, the fair market value of the securities will be treated as money, and Jeff will recognize a gain of $10,000 ($30,000 cash distribution minus $20,000 basis of partnership interest). The basis of the marketable securities will be $30,000 to Jeff, determined by adding the gain recognized to the basis as determined under the §732 rules.

[*] Section 732(a)(1).

The marketable security rule is intended to prevent a tax-free exchange of a share of appreciated partnership assets for an increase in a partner's share of partnership marketable securities. The term marketable security is quite broad, and includes a variety of traded financial instruments and may also include precious metals.[152] However, it does not include any securities that were contributed by the partner who receives the distribution, nor does it include any security that was not traded at the time it was contributed to the partnership.[153] It may include an interest in

[149] Regs. §1.737-3.
[150] Section 731(c)(1).
[151] Section 731(c)(4)(A).
[152] Section 731(c)(2).
[153] Section 731(c)(3)(A). Reg. §1.731-2(d) includes a more detailed discussion of the exceptions.

another partnership if substantially all of the assets of that partnership consist of marketable securities.[154]

If the marketable securities have a fair market value in excess of basis, the amount of the distribution treated as money is reduced by the distributee partner's share of the partnership unrealized gain.[155] This rule allows a partner to withdraw his share of the appreciation on partnership marketable securities without recognition of gain. It is only when a partner increases his share of partnership marketable securities, which increase is in exchange for her share of other partnership property, that the securities as money (or substance over form) rule applies.

Case Study 4-1: Avoiding Two Levels of Tax for Distributions

Facts

Hometown Bread is currently operated as a sole proprietorship. The sole owner is Harry Tyson, who is a widower with three children. Harry expects to transfer ownership interests to his children within the next few years to provide for an orderly succession plan and to enhance the childrens' interest in the business. All of the children will be able to work in the business if they so desire. Harry also has a grandchild who is permanently physically incapable of working, and Harry would like to create a preferred income stream from the corporation for that child's needs. He is also interested in liability protection and has approached you to discuss the choice of an entity that would meet his needs.

Discussion

If Harry wants to transfer ownership interests to his children when the entity is formed, an LLC would be a possible option. The children who are capable of working in the business could be compensated with guaranteed payments for their services. A guaranteed payment is one which is not determined by reference to income of the LLC.[156] Guaranteed payments are deductible by the LLC (unless general tax law principles would require capitalization) and are taxable to the recipients. A special allocation of profits, to be matched with cash distributions, could be made to the child with special needs. Such an allocation would require a more complicated LLC operating agreement to ensure that the agreement satisfies the substantial economic effect test.

If Harry is not interested in transferring ownership to the children at the time that the entity is formed, there are two available options for one-owner entities. The first is a single-member LLC. Although it would not be treated as a separate legal entity for income tax purposes, it would provide legal liability protection from the company's creditors. The other choice is a corporation, which can remain a C corporation or elect S status. An S corporation would avoid two levels of tax, but it would not be possible to create a preferential distribution scheme to benefit the child with special needs without violating the single class of stock requirement of §1361(b). If Harry is

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[154] Section 731(c)(2)(B)(v). Reg. §1.731-2(c)(2) would apply this rule if 90 percent or more of the assets of the partnership consist of marketable securities. Section 731(c)(2)(B)(vi) also allows a portion of a partnership interest to be treated as a marketable security if less than substantially all of the assets of the partnership consist of marketable securities. The Regulations apply this rule if at least 20 percent of the assets, but less than 90 percent, consist of marketable securities.
[155] Section 731(c)(3)(B).
[156] Section 707(c).

willing to transfer stock to that child with the same distribution terms as apply to all other shares, then an S corporation could be used. The stock may be held in either a qualified subchapter S trust or an electing small business trust.

If Harry wants to eventually create a preferred class of stock, a C corporation could be used. Harry could begin by making an S election for the corporation, and then later change to a C corporation when he issues preferred stock to the special-needs child. Alternatively, he could choose a C corporation from inception. The common criticism of C corporations is the potential for two levels of tax. However, if the majority of the corporate income is attributable to the services of Harry, it would be reasonable for Harry to withdraw corporate profits as deductible compensation. If the children are later hired as employees, it should be quite easy to remove all corporate profits as deductible compensation to Harry and the children.

If Harry uses a corporation, be it a C corporation or an S corporation, he should avoid a transfer of appreciated property. For example, equipment used in the bakery may be almost completely depreciated with the result that fair market value exceeds adjusted tax basis. It is best to lease such property to the corporation for two reasons. *First*, the rent payments will be deductible to the corporation, which will help remove profits from a C corporation without a second level of tax. *Second*, once appreciated property is inside a corporation, it cannot be distributed to the shareholders without a negative tax consequence. Any distributions not in liquidation of the corporation will result in recognition of gain under §311(b). Distributions in liquidation of the corporation will result in corporate gain recognition under §336. Even if the corporation is an S corporation, a distribution of appreciated property will result in immediate gain recognition by the shareholders.

Case Study 4-2: Avoiding Gain Recognition from Property Distributions

Facts

Scott and Bill will form an entity to develop real property that is currently separately owned by each of the individuals. Liability protection is an important consideration and both owners will be actively involved in the business of the entity. The current plan is for the entity to sell the property when it is in its developed state. However, it is possible that Scott may want to enter into a like-kind exchange with his share of the property (you may assume that Scott has a defensible position that, after development, he will not be considered to have held the property for sale). Thus, the parties are aware of the possibility that the entity may need to be liquidated by a distribution of an undivided share of the property to the owners, followed by a taxable sale by Bill and a sale with a deferred exchange by Scott.

Discussion

The parties should form an LLC. To satisfy the objective of liability protection and active management by both owners, a corporation or an LLC would be available options. However, the possibility that property may later be distributed so that Scott may enter into a deferred exchange suggests that a corporation (C or S) is not viable.

If a corporation distributes appreciated property, whether in liquidation or not, the corporation must recognize gain as if the property were sold to the distributee at fair market value. To avoid two levels of tax, Scott and Bill would no doubt prefer an S election if a corporate form is

selected. However, if the S corporation later distributed appreciated property, the corporation would be required to recognize gain. Although that gain may be passed through to the shareholders, the effect would still be to recognize all gain before either shareholder could separately determine what he wanted to do with the property.

If the property were later distributed from an LLC, there would be no tax effect to the LLC and the members would probably not be taxed when the property was received. Section 731 would suggest that the members would not be taxed on receipt of any property. However, because both members are contributing appreciated property, which is subject to §704(c) allocations, a later distribution of property may cause gain to be recognized under either §704(c)(1)(B) or §737. These sections apply if the property is distributed within seven years of the contribution. Therefore, before selecting the LLC form, or before making any distributions of property, the member's tax advisor(s) should consider the implications of these provisions. Even with these risks, the LLC will likely be the better alternative since it would normally be expected that the recognized gain will be less under the partnership provisions of §704(c)(1)(B) or 737 instead of §311(b) or 336.[157]

In this case, the recommendation is still to use an LLC because the LLC allows for the possibility of a later distribution of property with no immediate tax consequences to either the entity or the owners. In contrast, a distribution from an S corporation ensures that gain will be recognized. Also, both §§704(c)(1)(B) and 737, even if applicable to a future distribution, will only cause the precontribution gain to be recognized. The appreciation that occurs after the property is contributed, including that attributable to development activities, will be deferred by using the form taxed as a partnership.

Case Study 4-3: Disproportionate Distribution-Partnership Complexity

Facts

The HJK balance sheet appears as follows:

	FMV	Tax Basis
Cash	$60,000	$60,000
Unrealized Receivables	90,000	20,000
Inventory	110,000	90,000
Capital Assets	340,000	190,000
Total	$600,000	$360,000

Henry, who holds a one-third interest with a basis of $120,000, receives all of the inventory and unrealized receivables in a distribution in liquidation of his interest.

Discussion

If the entity is a C corporation or an S corporation, the entity will be required to recognize $90,000 of ordinary income under §311(b). Henry's share of this gain will be $30,000 if the

[157] If the property has decreased in value rather than appreciating since it was contributed to the entity, this may not be the case. The tax burden facing the partners will be impacted by the choice of which method (traditional, curative, or remedial) was selected to deal with the built-in appreciation at the time of contribution.

entity is an S corporation, which will increase the basis of his stock to $150,000. The distribution in complete redemption of his stock will result in a $50,000 capital gain ($200,000 received minus $150,000 stock basis). If the entity is a C corporation, the corporation will pay tax on the $90,000 gain, none of the gain will flow through to Henry and the other stockholders, and Henry will recognize an $80,000 capital gain ($200,000 received less $120,000 stock basis) when his shares are fully redeemed.

If the entity is a partnership or an LLC, the general rules of §731 and §732 (absent §751) would bring about the following result:

- The basis of the inventory remains at $90,000 and the basis of the unrealized receivables at $20,000.
- Henry recognizes a loss of $10,000 from the distribution because the basis of his interest ($120,000) is first assigned to the ordinary income assets as shown above, and he has $10,000 of basis that cannot be assigned.
- When Henry later sells the ordinary income assets, he recognizes $90,000 of ordinary income, assuming no change in fair market value. Thus, overall, he recognizes net gain of $80,000 (capital loss of $10,000 and ordinary income of $90,000).

The problem with the above result is that all of the ordinary income inherent in partnership assets has been recognized by one partner. Section 751 will recharacterize the transaction as follows:

- Henry has exchanged a one-third interest in cash and capital assets (FMV = $133,333) for a two-thirds interest in inventory and unrealized receivables (FMV = $133,333). That is, he gave up his interest in the capital assets and received an additional interest in ordinary income assets.
- The two remaining partners have exchanged a two-thirds interest in inventory and unrealized receivables (FMV = $133,333) for a one-third interest in cash and capital assets (FMV = $133,333). That is, the remaining partners gave up their interests in the ordinary income assets and received an additional interest in the capital assets.
- The above transactions are treated as taxable sale or exchange transactions. Thus,
    - Henry is treated as if he first received a one-third share of all assets, including the capital assets, and then sold the capital assets to the partnership. Basis is allocated among all assets using the rules of §732. The allocation is $20,000 to cash, $36,667 to ordinary income assets (carryover), and $63,333 (the remaining outside basis) to the capital assets. He recognizes a gain on the sale of the capital assets (his one-third share) equal to $50,000 ($113,333 – $63,333).
    - The basis of the ordinary income assets to Henry is determined in two parts. First, he has a carryover basis of $36,667 in one-third of the ordinary income assets, determined under the provisions of §732. Second, he has a cost basis ($133,333) in the two-thirds deemed purchased from the partnership. Thus, his overall basis is $170,000. When he later sells the ordinary income assets, he will recognize ordinary income of $30,000, which is the same answer as obtained if the entity were an S corporation.

- The partnership has sold a two-thirds interest in ordinary income assets in exchange for a one-third interest in capital assets. Thus, the partnership has an amount realized of $133,333 in exchange for assets with a basis of $73,333. The partnership recognizes $60,000 of ordinary income, allocated between the two continuing partners, resulting in each recognizing their $30,000 share of the ordinary income potential in partnership assets.
- The basis of undistributed partnership assets is then also determined in two parts. The initial basis is $250,000, of which two-thirds, or $166,667, belongs to the continuing partners. The remaining one-third was *purchased* by the partnership for the fair market value of $133,333. Thus, the aggregate basis is $300,000. A later sale would result in $100,000 of capital gain, which would be divided $50,000 to each of the two continuing partners.

The net result of the deemed purchase-sale transaction as shown in the above example is that all partners will ultimately report $30,000 of ordinary income and $50,000 of capital gain, in proportion to their respective interests in partnership properties.

This result is similar to that of an S corporation—Henry recognizes $30,000 ordinary income and $50,000 capital gain and the other owners recognize $30,000 ordinary income. Note that §751 causes a tax result that is no worse than what would occur if the distribution had been made by an S corporation. However, the mechanics of the §751 provision are more complicated than the §311(b) rule applicable to distributions from an S corporation. It should also be noted that while §751 works out to be a rough equivalent of the S corporation treatment in this distribution setting, §751 may be a much worse alternative in the case of the sale of an interest. The sale of S corporation stock is not subject to §751.

Case Study 4-4: Distributions of Marketable Securities

Facts

Four individuals propose to form an entity for the purpose of acquiring and investing in marketable securities. When the owners require cash to pay taxes and for other reasons, the entity will distribute marketable securities proportionately to the owners' interests. It is proposed that any owners who need cash will sell the distributed securities and that those who do not need cash will simply hold the securities outside of the entity. However, all owners will receive a distribution to avoid disproportionate distributions that alter the owners' future rights to assets of the entity.

Discussion

Effective for distributions occurring after December 8, 1994, the term money for purposes of §731(a)(1) includes the fair market value of marketable securities distributed to a partner. This rule does not, however, apply for purposes of §731(a)(2), which allows a loss to be recognized from certain liquidating distributions. Thus, the receipt of any marketable securities in a liquidating distribution will prevent a partner from recognizing a loss. However, a partner who receives a distribution of marketable securities with a fair market value in excess of the basis of his partnership interest will be required to recognize gain and the basis of such marketable securities will be the basis as determined under §732 increased by any gain recognized in the

distribution.[158] The partnership will not adjust the basis of undistributed property by the amount of gain recognized by the partner, even if a §754 election is in effect.

If the marketable securities have a fair market value in excess of basis, the amount of the distribution treated as money is reduced by the distributee partner's share of the partnership unrealized gain.[159] This rule allows a partner to withdraw his share of the appreciation on partnership marketable securities without recognition of gain. It is only when a partner increases his share of partnership marketable securities, which increase is in exchange for her share of other partnership property, that the securities as money (or substance over form) rule applies.

There is no reason to risk the potential for two levels of tax. Because the entity will simply hold investment assets, it will be difficult to justify compensation payments to the owners for the purpose of avoiding a corporate tax in a C corporation. Thus, the entity should be a flow-through entity.

If appreciated securities are distributed from an S corporation, the corporation will be required to recognize gain under §311(b). The S corporation will not pay any tax, but each shareholder will be required to report his or her share of the gain. The shareholders' basis in the distributed securities will then be fair market value, and any shareholder who immediately sells the distributed securities will not recognize any further gain. It is only the shareholders who do not plan to sell the distributed securities who will pay a tax earlier than they would prefer.

The LLC or general partnership form would generally permit a distribution of appreciated property without recognition of any gain by the entity or the owners. However, when the distributed property consists of marketable securities, a gain may have to be recognized by the distributee pursuant to §731(c). This provision treats certain marketable securities as money for purposes of applying the rule that a partner recognizes gain when a distribution of money exceeds the basis of the partner's interest.

Because the amount of marketable securities treated as money is reduced by the distributee's share of any unrealized appreciation, the amount of the distribution that may be taxable will be less than if the appreciated marketable securities had been distributed by a corporation. Thus, use of an LLC or a general partnership will result in a different amount of gain recognition relative to certain S corporation distributions.

Assume that the four owners each have a basis of $20,000 in their ownership interests. Now assume that the entity distributes, to each owner, marketable securities with a fair market value of $15,000 and a basis also of $15,000. Section 311(b) will not require any gain recognition if the distributing entity is an S corporation because the securities are not appreciated. The shareholders' basis in the distributed securities is $15,000 and the basis of their stock is reduced to $5,000. The same result occurs in a partnership. The securities are treated as money, but because the amount of the distribution does not exceed the basis of the partners' interest, no gain is recognized. If the value and basis of the securities is instead $30,000, the owners will recognize $10,000 of gain whether the entity is an S corporation or a partnership.

[158] Section 731(c)(4)(A).
[159] Section 731(c)(3)(B).

The preceding discussion shows that, in many cases, the effects on the owners may be the same whether the entity is an S corporation or a partnership. Before December 9, 1994, marketable securities distributed by a partnership were not treated in the same manner as money. Partnerships lost some of their advantage over S corporations with respect to distributions of marketable securities. However, if the securities are appreciated, partnerships may still offer advantages.

Assume that the ABCD four-person partnership has, among other assets, marketable securities that will be distributed to the partners. The securities have an aggregate fair market value of $400,000, and each partner's share of the fair market value and tax basis of the securities is as follows:

	One Fourth of Fair Market Value	One Fourth of ABCD's Basis	One Fourth of Appreciation
Security A	$60,000	$20,000	$40,000
Security B	$20,000	$15,000	$5,000
Security C	$20,000	$5,000	$15,000
Totals	$100,000	$40,000	$60,000

Further, each partner has a basis in his partnership interest of $30,000. Now assume that each owner receives a share of the securities valued at $100,000. Each partner's share of the unrealized appreciation in each security is 25 percent. The three securities will be treated as one for purposes of applying the §731(c) rules. The total fair market value (FMV) of the securities exceeds the basis to the partnership by $240,000 and each partner's share of the unrealized appreciation is $60,000 [.25 × $240,000]. The amount of the distribution treated as money is then $40,000 [$100,000 FMV reduced by each partner's share of the unrealized appreciation]. Each partner must recognize $10,000 of gain from the distribution, the deemed distribution of money in excess of his basis in his interest. Each partner's basis in the three securities received in the distribution will be $40,000, the sum of the basis determined under §732 [$30,000 substituted basis from his partnership interest] and the $10,000 gain recognized under §731(c). Note that each partner has a realized gain of $70,000 when he exchanges a partnership interest with a basis of $30,000 for securities valued at $100,000. He recognizes $10,000 of this gain when the distribution occurs, with the result that he has deferred $60,000 of gain [$70,000 realized gain minus $10,000 recognized gain equals $60,000 deferred gain]. When the securities are sold, the deferred gain will be recognized.

Section 732(c) will allocate this $40,000 basis in two steps. First, the $30,000 of basis that represents a substituted basis of the partner's partnership interest is allocated in proportion to the adjusted basis of each of the securities to the partnership. Second, the $10,000 additional basis created by the recognition of gain is allocated in proportion to the unrealized gain in each security.

Security	Step 1	Step 2: Gain Adjustment	Total Basis
A	$20,000 × 30/40 +	$10,000 × 40/60	$21,667
B	$15,000 × 30/40 +	$10,000 × 5/60	$12,083
C	$5,000 × 30/40 +	$10,000 × 15/60	$6,250
Total			$40,000

Generally, any gain recognized under §731(c) will be capital gain. The exception occurs when the distributed securities are either inventory or unrealized receivables as described in §751.[160]

If the same distribution of appreciated property had been made from an S corporation, each shareholder would report $60,000 of gain as a result of §311(d). The shareholders' stock basis will then increase to $90,000. The distribution of securities valued at $100,000 will cause each shareholder to recognize another $10,000 of gain because the distribution exceeds the shareholder's stock basis. Thus, each shareholder will report a total gain of $70,000 and the basis of the securities will be $100,000.

If all owners intend to sell distributed securities in the same year as the distribution occurs, it does not matter whether a partnership or an S corporation is selected. If, however, one or more owners intend to hold all or a portion of the distributed securities, the partnership form will allow for a potential deferral of gain when the distributed securities are appreciated.

To maintain the flexibility of possibly deferring all or a portion of the gain attributable to distributions of appreciated securities, it is recommended that a partnership (or LLC) form be selected based on the facts in this case.

[160] Section 731(c)(6).

Chapter 5

Sales and Reorganizations

Overview

Since we cannot take it with us in the end, at some point the business owner will transfer the business to another party. This may occur through a planned sale as discussed in this chapter, or through the gift and estate system as described in the next chapter. The choice of how the business will be passed can have implications for the form chosen. While the exact specifics of who will buy the business in case of a sale may not be known at inception, if the owner at least has knowledge of whether he or she would like to ultimately gift the business to family members or sell the business to an outside buyer or a key employee, the entity decision can be clarified.

It is also possible that the business will need to be reorganized. This chapter will discuss reorganizations of the business entity, including the acquisition of a new business and the ease of exiting the selected form when it is no longer appropriate to the needs of the business and its owners.

Sales of Business Interests

Sale of Stock or Assets

If the business has increased in value, the most convenient and tax efficient form of sale for the business owner is a sale of stock. This is advantageous to the seller because this treatment will most often result in capital gain treatment.[161] In 2010, this will result in most individuals facing a 15 percent tax rate for the sale transaction.[162] Unlike the case of the partnership, which is subject to §751, there is no look-through to the underlying assets of the business entity in a stock sale.[163]

The difficulty of obtaining stock sale treatment is that the buyer of the business will typically desire a step-up in the basis of its assets to fair market value. This only occurs if the buyer purchases assets and not stock (or treats the stock sale as an asset purchase which is then taxed as if assets had been sold). Buyers typically desire to buy stock only if certain rights or permits are tied to the corporation and would be difficult or impossible to transfer through an asset purchase.

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[161] The sale of a business interest discussion in this chapter focuses on an individual owner. Corporations do not have the same preferential treatment with regard to tax rates as individuals.
[162] Those individuals normally facing a 10 or 15 percent maximum rate on ordinary income would have a capital gains tax rate of zero in the current year. This preferential rate is set to expire in two years; therefore, the degree of preference for a stock sale may diminish if the capital gains rate returns to the 20 percent rate in 2013.
[163] An S corporation stock sale would face look-through for collectibles gain (28 percent), while a partnership would face look-through for both the §1250 gain (25 percent) and collectibles gain (28 percent) in addition to the rules of §751.

Of course, the purchase price agreed to by the buyer and seller should reflect the method of sale. In other words, the seller should be willing to accept a lower cash price for the business if a stock sale is accomplished since he or she would be paying less tax than would be the case in an asset sale. Likewise, a buyer should be willing to pay more to purchase assets than would be the case for a stock purchase.

In addition to the standard capital gains treatment on the sale, if the corporation is a C corporation and otherwise qualifies, it is possible to obtain even greater savings on the stock sale through the application of §1202. Under §1202, the remaining gain from the sale of qualifying Section 1202 stock (up to 50 percent of the gain may be excluded)[164] is subject to a maximum rate of 28 percent. This effectively makes a 14 percent capital gains rate on a qualifying stock sale rather than the standard 15 percent. Should the standard capital gains rate increase, the relative value of qualifying under §1202 would increase.

It should also be noted that alternative minimum taxable income is increased for a percentage (currently 7 percent) of the excluded gain, which reduces the benefit of §1202 for those owners facing AMT.

Section 1202 stock must be held for five years rather than the standard long-term period of one year. Also, §1202(b)(1) limits the amount of gain eligible to the greater of $10,000,000[165] (reduced by the total gain taken into account by the taxpayer in prior years related to this corporation's stock), or 10 times the aggregate adjusted bases of the qualified stock of that corporation disposed of by the taxpayer that year. This basis amount is determined without additions to the stock basis made after it was originally issued.

Qualifying stock must have been issued after August 10, 1993, by a C corporation. The aggregate adjusted basis of its gross assets cannot be more than $50,000,000. Also, 80 percent or more of its assets must be used in the active conduct of a qualifying business. Certain types of businesses are specifically excluded by §1202(e). These excluded businesses include any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees; any banking, insurance, financing, leasing, investing, or similar business; any farming business; any business involving the production or extraction of products of a character with respect to which a deduction is allowable under §§613 (percentage depletion) or 613A, and any business of operating a hotel, motel, restaurant, or similar business.

Other specific rules apply for situations such as those involving redemptions, subsidiaries, stock held by pass-through entities, and small business investment companies.

If a business chooses to sell assets rather than stock, the gain or loss is calculated on each asset individually. This will result in the buyer obtaining a step-up in basis to the fair market value

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[164] Section 1202(a)(2) currently provides a 60 percent rule for empowerment zone business through 2014. In addition, the 2009 Stimulus Act increases the percentage to 75 percent for qualifying stock acquired after February 17, 2009 and through 2010. Subsequent Small Business and Tax Relief Acts have provided for a 100 percent exclusion on qualifying stock issued after September 27, 2010 through calendar 2011. This 100 percent exclusion is also not subject to an AMT adjustment.

[165] Married couples filing separately are limited to $5,000,000 per individual.

consideration paid for the asset. It also means that the seller will have to determine the type of income on an asset by asset basis. This means that much of the gain could be ordinary due to the nature of the assets sold (inventory or receivables or recapture).

A sole proprietorship (or single member LLC taxed as a sole proprietorship) will face asset sale treatment when disposing of an interest.

Sale of Partnership Interest

The sale of a partnership interest also has a general rule, per §741, that will result in capital gain or loss to the partner on the sale of the partnership interest. However, this general rule is overridden by §751 when the interest contains hot assets. Recall that hot assets include unrealized receivables and inventory, and that depreciation recapture is also considered to be a hot asset.

The result of §751 is that for those partnerships that contain ordinary income assets, the resulting gain on the sale of the interest may be characterized as ordinary income. In the extreme case of a business whose ordinary income assets have appreciated and whose capital assets have lost value, the ordinary income component may be larger than the total gain on the sale. In such a case, the partner will have a capital loss such that the ordinary income and capital loss in total equal the total gain on the transaction. Since capital losses are limited to a capital loss of $3,000 in excess of capital gains, many taxpayers will obtain little current benefit for the capital loss portion while having to recognize the ordinary income.

COMPARATIVE EXAMPLE

To demonstrate the effects of sale treatment, assume that a business entity (ABC) with three equal owners (A, B, and C) exists. C has decided to sell her interest in the business to another individual D. The ABC entity contains only two assets, unrealized receivables with a basis of $0 and a value on the date of sale of $3,000, and a capital asset with a basis of $6,000 and a value on the date of sale of $18,000. Also assume that C's basis in her partnership interest is $2,000.[166] If the value of the business is the value of its underlying assets, the value of the business in total is $21,000 and a one-third share is worth $7,000.[167]

If C's interest consists of stock in a C corporation, she would recognize $7,000 of proceeds less her $3,000 basis, which results in a gain of $4,000. This gain would typically be capital and face a rate of 15 percent. If so, the tax on the transaction would be $600.[168] If the stock qualified as §1202 stock, the gain could be as low as $280 if 75 percent of the gain was eligible for exclusion. ($280 equals $4,000 total gain less $3,000 (75 percent) gain excluded taxed at 28 percent.)

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[166] This case is the simple case in which the owner's outside basis is equal to the owner's proportionate share of the inside asset basis. This need not be the case in reality but is used here for ease in demonstrating the basic sales concepts.
[167] This represents a situation in which there is no goodwill, and there is no reduction in the owner's value due to a lack of control.
[168] This example assumes that the taxpayer has no outside capital losses that could offset this capital gain.

If the interest consists of S corporation stock, she would again recognize $7,000 of proceeds less her $3,000 basis again resulting in a gain of $4,000. This gain would typically be capital and face a rate of 15 percent, for a tax liability of $600. S corporation stock gain cannot be lowered through the use of §1202.

If her interest consists of a partnership interest, §751 would cause the $4,000 total gain to be split between ordinary and capital portions. She would be viewed as having sold a one-third interest in the unrealized receivables, which would result in $1,000 of ordinary income. The remaining $3,000 of gain would then be capital in nature. Assuming that C is normally in the 35 percent ordinary tax bracket, the tax on the sale is composed of $350 in tax on the ordinary income portion and $450 on the capital portion for a total of $800.

This example demonstrates that the tax disadvantage of a partnership interest sale compared to a stock sale is determined by the portion of the gain reclassified as ordinary and the difference in tax rates on ordinary income and capital gains.

The case of an asset sale is essentially that of the partnership setting. The gain would be calculated on each individual asset, but in the single-owner case, the entity would be considered a proprietorship rather than a partnership.

Prior to disposing of the business, the owner may find it advantageous to restructure the entity to accomplish business goals. The remaining sections of this chapter will discuss acquisitions and restructurings of entities.

Using Corporations in Nontaxable Acquisitions

A business acquisition may be structured to be taxable or nontaxable. The advantage of a nontaxable acquisition is to delay the time at which tax payments must be made. However, nontaxable transactions must be structured to comply with statutory requirements, and the parties to the transaction may be unwilling to satisfy one or more of the requirements.

Nontaxable corporate acquisitions may take one of the following forms:

- Nontaxable Asset Acquisitions
    - A statutory merger or consolidation (which may be a forward or a reverse merger);
    - A forward triangular merger (distinguished from a merger because a subsidiary is used as the Acquiring Corporation and additional requirements must be satisfied); or
    - A contractual acquisition of assets in exchange for voting stock.
- Nontaxable Stock Acquisitions
    - An acquisition of stock in exchange for voting stock or
    - A reverse triangular merger (in which the Target survives).

To satisfy the requirements for a tax-free acquisition, a transaction must meet certain definitional rules of what a nontaxable acquisition is. If the definitional rules are met, then the operational rules applicable to nontaxable acquisitions explain what the resulting tax treatment is to all parties to the reorganization.

When tax practitioners think of nontaxable acquisitions, what comes to mind is the "alphabet" of acquisition forms: Type A; Type B; and Type C. (Type D may also be an acquisition form, although it is most commonly a division of a corporation. Types E (recapitalization), F (change of identity, form, or place of organization), and G (bankruptcy) are not used for acquisitions.)

Types A, B, and C refer to a definition of a form of acquisition as found in §368(a)(1). That is, an "A" reorganization is described in §368(a)(1)(A), a "B" in §368(a)(1)(B), and so on. Section 368 is a definitional provision only; it merely defines what a reorganization is for purposes of applying §301 to §368.

The key operating provisions applicable to nontaxable acquisitions are found in §§354, 356, 357, 358, 361, 362, and 1032. It is easier (although not easy) to understand the tax result of a corporate acquisition by reference to the operating provisions. Once the operating provisions are understood, we can then review the definition of a corporate reorganization to which those operating rules apply.

Operating Rules of Corporate Reorganizations

There are generally three parties to a corporate reorganization—the Target Corporation (Target), the shareholders of the Target Corporation, and the Acquiring Corporation (Acquiring). Of course, the shareholders of the Acquiring Corporation also have an interest in the acquisition, and may need to approve the transaction by affirmative vote, but shareholders of Acquiring generally do not receive any property and thus experience no immediate tax effect from the transaction.

Corporate reorganizations are complicated because the deal points are often very complex; that is, the devil is in the details. But the general provisions governing reorganizations are readily understandable to a practitioner with experience in nontaxable exchanges.[169]

The principle underlying the nontaxability of a corporate reorganization is a continuation of investment in an alternative form. That is, the taxpayer, by continuing to own property similar to the property surrendered, has not converted the substantive nature of her investment so as to justify a taxable transaction. The mechanism to ensure that the nonrecognition of gain is a deferral only, and not an exclusion, is the basis of the property received in the exchange.

If the shareholder of a corporation surrenders his stock and in exchange receives stock in Acquiring, there is a change in form only, and not in substance, of the investment. The shareholder may recognize no gain, but the basis of the stock received will be adjusted to ensure that any gain realized in the exchange, but not recognized, is deferred. If the shareholder receives property other than qualifying property (boot), gain will be recognized equal to the lesser of the value of the boot or the gain realized from the exchange.

[169] A letter ruling is often requested by the taxpayer in order to confirm that the non-taxable nature of the transaction will be respected by the Service.

Target, as a party to the reorganization, will also generally recognize no gain or loss because it experiences no change in the substance of its investment. Acquiring must use stock as part of the consideration and is protected by a general rule of tax law that a corporation recognizes no gain or loss when dealing in its own stock or securities.

The basic tax result of a nontaxable acquisition is no more complicated than that of any other nontaxable exchange.[170] Using a basic knowledge of nontaxable exchanges, we may say that the result of a nontaxable corporate acquisition *should*, if it follows general principles of nontaxable exchanges, be as follows:

- Target shareholders should generally recognize no gain or loss.
- The basis of qualifying property received by Target shareholders should be determined so that any gain realized, but not recognized, from the exchange is merely deferred.
- If the Target shareholders receive any boot property, they should recognize any realized gain to the extent of the value of the boot received.
- Target should recognize no gain or loss provided it realized no change in the substance of its asset holdings.
- Acquiring should recognize no gain or loss for use of its stock or securities to effect the acquisition.

Treatment of Target Shareholders (§§354, 356, and 358)

Section 354 provides that no gain or loss will be recognized if stock or securities in one corporation are exchanged solely for stock or securities in another corporation, if both corporations are parties to a reorganization.

Section 354 allows a shareholder of Target to exchange stock in Target for stock in Acquiring.

There are two exceptions to the general rule of nonrecognition of gain by Target shareholders:

1. First, if the taxpayer receives securities in Acquiring, gain is recognized if the principal amount of the securities received exceeds the principal of any securities surrendered.[171]
2. Second, if any consideration other than stock or securities is received, gain is recognized to the extent of the value of such boot property received.[172]

If gain is recognized under the above rules, §356(a)(2) states that the gain may be a dividend if the transaction has the effect of a dividend distribution. The principles of §302, applicable to stock redemptions, apply in determining the character of the gain.[173]

The Target shareholder's basis in property received in a nontaxable reorganization is as follows:[174]

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[170] For example, like-kind exchanges (§1031), involuntary conversions (§1033), and rollover of gain from the sale of qualified small business stock (§1045) operate on the same principle as tax-free corporate reorganizations.
[171] Section 354(a)(2).
[172] Section 356.
[173] *Clark*, 63 AFTR 2d 89-860 (S. Ct., 1989).

- For stock or securities received (qualifying property), basis is the basis of the property surrendered reduced by the money and value of any boot obtained and increased by any gain recognized.
- For boot property received, basis is the fair market value.

Treatment of Target Corporation §§357, 361, and 381

Section 361(a) states that no gain or loss is recognized by a corporation that is a party to a reorganization from the exchange of property solely for stock or securities in another corporation that is a party to the reorganization.

Section 361(a) will protect Target from recognizing gain on the transfer of its property to the Acquiring Corporation. To qualify for nonrecognition treatment, Target must distribute any property it receives in the exchange. Thus, if Target receives boot property, the tax result is as follows:

- If Target distributes the property to its shareholders, Target recognizes no gain.
- If Target retains the boot property, Target recognizes gain equal to the sum of any money and the fair market value of property retained.

The preceding discussion refers to the tax treatment of Target's distribution of property received from Acquiring. In connection with the acquisition, Target may distribute some of its property that Acquiring does not want to acquire. A distribution of property other than that received from Acquiring (as part of the plan of reorganization) would be subject to the §311 rules (if the distribution is not in liquidation of Target) or §336 (if the distribution is in liquidation of Target). Both §§311 and 336 require the distributing corporation to recognize gain as if distributed property were sold to the shareholders at fair market value.

Because Target would not typically retain any property received from Acquiring, Target rarely recognizes any gain from a plan of reorganization.

Section 357(a) provides that the assumption of Target's liabilities shall not be treated as the receipt of boot. However, if the assumption lacked a bona fide business purpose or was for a tax avoidance motive, the amount of liabilities assumed shall be boot.[175]

Section 381(b)(1) states that Target's taxable year shall end as of the date of distribution or transfer, which is generally the date on which the distribution or transfer is completed. A short-period return is then required if the reorganization transaction occurs during the Target's tax year.

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[174] See §358(a)(1) for qualifying property and §358(a)(2) for boot property.
[175] Section 357(b).

Treatment of Acquiring Corporation—§§362, 381, and 1032

Section 1032 states that no gain or loss shall be recognized when a corporation exchanges its stock or securities for property. Thus, Acquiring recognizes no gain because of the receipt of property.

Section 362(b) provides that the basis of property received by Acquiring in a plan of reorganization is equal to the basis of such property to the transferor increased by any gain recognized by the transferor. One or more of Target shareholders will often recognize gain in an otherwise nontaxable reorganization because some of the consideration consists of boot. Acquiring does not obtain any basis increase for such gain under the rules of §362(b), because Target, and not the shareholders of Target, is the transferor in a reorganization. Target Corporation will recognize gain only if it receives property in the reorganization and fails to distribute it to its shareholders. Target rarely recognizes gain because property received is distributed. Thus, the basis of assets to the Acquiring Corporation will almost always equal the basis that such assets had to Target. Notice that it is logical that gain recognized by a shareholder should not affect the basis of assets held in corporate solution. To maintain the two levels of taxation, it is necessary to limit any basis adjustment to gains recognized by the corporate transferor—to do otherwise would allow the parties to reduce the corporate level of tax.

Because the basis of assets will carry over to Acquiring, the holding period of such assets includes the holding period of the transferor.[176]

Section 381 states that tax attributes of Target will carry over to Acquiring if the acquisition is a Type A or Type C. Type B acquisitions are acquisitions of the stock of Target. Because Target retains its corporate existence in a Type B acquisition, there is no need for attributes to carry over because they stay with the Target. Tax attributes that carry over are listed in §381(c). The ability to use attributes may be limited, however, by §§269, and 382 through 384.

Judicial Doctrines Applicable to Reorganizations

Three judicial doctrines apply to all nontaxable corporate reorganizations. The three doctrines are

- Continuity of Proprietary Interest,
- Continuity of Business Enterprise, and
- Business Purpose

Because the concept underlying nonrecognition of gain in a corporate reorganization is a continuation of investment in an alternative form, it is necessary for the shareholders of Target to continue their role as equity owners, albeit in Acquiring.

The doctrine of continuity of interest merely recognizes that nonrecognition of gain is inappropriate when the taxpayer has changed the substance of his investment. Thus, the Supreme Court held that an exchange of stock in Target for cash and short-term notes issued by Acquiring

[176] §1223(2).

did not qualify as a reorganization.[177] However, the receipt of 56 percent common stock consideration and 44 percent cash did qualify as a reorganization.[178]

The continuity of interest doctrine may now be found in the Regulations[179] and in many of the definitional rules applicable to corporate reorganizations. For example, a Type B reorganization requires that only voting stock consideration be used, and a Type C requires that substantially all of Target assets be acquired in exchange for voting stock.

The Supreme Court has held that an acquisition in which Target shareholders received only 36 percent stock consideration was a reorganization.[180] However, for purposes of issuing a favorable advance ruling, the IRS requires that stock consideration received by Target shareholders (in the aggregate) must equal at least 50 percent of the value of the stock of Target.[181] Notwithstanding, the IRS ruling guideline, Reg. Section 1.368-1(e)(2)(v), Example 1, concludes that continuity of interest is satisfied with 40 percent stock consideration. This example was added to the regulations effective for transactions entered into after September 16, 2005.

Not all Target shareholders need receive stock consideration to satisfy continuity of interest. The only requirement is that shareholders in the aggregate receive a sufficient amount of stock consideration. Any shareholder(s) receiving nonstock consideration will be required to recognize gain under the boot relaxation rules of §356. In contrast, if the continuity of interest is not met, there is no valid reorganization and all shareholders, even those receiving stock, are subject to tax.

Because the Type B and Type C reorganizations, as discussed above, require that stock consideration be used to acquire more than 50 percent of the value of Target stock, continuity of interest is generally only an issue in Type A reorganizations. However, transitory stock ownership may be a concern in any type of reorganization. If the shareholders of Target have a prearranged plan to sell Acquiring shares shortly after the reorganization, such shares may be excluded in meeting the continuity of interest test. The IRS will generally recognize continuity of interest provided shareholders have the right to maintain ownership for five years.[182]

Regulations §1.368-1(b) states that a reorganization requires a continuity of business enterprise under modified corporate form. Regulations §1.368-1(d) provides two means to satisfy the continuity of business enterprise requirement. Acquiring must satisfy one of the following two requirements:

1. Continue to operate the historic business of Target or
2. Continue to use a significant portion of the historic business assets of Target in a trade or business.

The existence and nature of a "historic" trade or business, or the assets of such a business, is a facts and circumstances determination. However, if Target sells a large portion of its assets and

[177] *Pinellas Ice & Cold Storage Co.*, 287 US 462 (1933).
[178] *Minnesota Tea Co.*, 296 US 378 (1935).
[179] See Reg. §1.368-1(b).
[180] *John A. Nelson*, 296 US 374 (1935).
[181] Revenue Procedure 77-37, 1977-2 C.B. 67.
[182] Revenue Ruling 66-23, 1966-1 C.B. 67.

purchases new assets, a reorganization shortly after the sale and purchase will probably be taxable. This is because the new business assets fail to constitute the historic business of Target.

A nontaxable acquisition requires an exchange pursuant to a plan of reorganization. The Supreme Court has held that a plan of reorganization cannot exist independent of a business purpose.[183]

Treasury Regulations promulgated under §368 refer to the need for a business purpose in §§1.368-1(b), 1.368-1(c), and 1.368-2(g). Thus, it is clear that an acquisition cannot be nontaxable if the plan lacks a business purpose.

DEFINITIONAL RULES OF REORGANIZATIONS: THE ALPHABET APPROACH

Type A

A merger or consolidation, referred to as a Type A,[184] is perhaps the easiest of the reorganization provisions to satisfy. The most significant hurdle is that the transaction must comply with state or federal statutes governing such a transaction. For example, the requirements of a state statute regarding a merger must be satisfied.

A merger involves the acquisition of one corporation by another, in which the acquired corporation goes out of existence. Acquiring then succeeds to all assets and liabilities of the merged Target. Shareholders of the merged Target automatically become shareholders of the surviving Acquiring entity.

A consolidation involves the combination of two or more corporations into a single (and new) corporation with the consolidated entities going out of existence.

A merger is the most common form of acquisition and has very flexible consideration rules. The tax law imposes no specific requirements on the type of consideration to be used. Thus, the continuity of interest requirement is the only restriction on consideration. For advance ruling purposes, at least 50 percent of the value of Target stock must be received in stock.[185] However, the stock consideration may be voting or nonvoting, or preferred or common.

An S corporation may be the acquiring corporation in a merger provided the stock issued to Target shareholders does not create a second class of stock, that none of Target shareholders receiving stock in the S corporation are ineligible shareholders, and that the maximum shareholder limit is not exceeded. A built-in-gains tax exposure will exist if Target was a C corporation. The S corporation may also be the Target; however, great care must be taken here if S status is to be maintained as the only type of corporation that can own another S corporation is another S that owns 100 percent of the subsidiary's stock. If Acquiring is a C corporation, the subsidiary created to effectuate a forward triangular merger may not be an S corporation (a C corporation is an ineligible shareholder). An S corporation may set up a C corporation subsidiary or an S corporation subsidiary (the parent S corporation must own 100 percent of the S

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[183] *Gregory v. Helvering*, 293 US 465 (1935).
[184] Recall that Type A (and B, C, and so on) means that the provision is described in §368(a)(1)(A) of the Internal Revenue Code.
[185] Section 3.02 of Revenue Procedure 77-37, 1977-2 CB 568.

subsidiary and an election must be made to qualify the subsidiary) to carry out a forward triangular merger.

A merger may be advisable if Acquiring is unwilling to transfer voting stock to Target shareholders. Because it is typically true that a “small” corporation is merged into a “large” corporation (that is, the big fish swallows the little fish), the former shareholders of Target will receive less than 50 percent of the voting stock in Acquiring. Nonetheless, a minority interest concentrated in the hands of a few shareholders may actually exert control over Acquiring.

A concern in many merger transactions is that Acquiring assumes all liabilities of the Target. If Target liabilities are a concern, a forward triangular merger may be advisable. Forward triangular mergers may also relieve the burden of obtaining the approval of Acquiring Corporation shareholders.

In a forward triangular merger, Acquiring forms a new subsidiary, funded with stock in Acquiring and any other consideration to be used in the acquisition of Target. Target is merged into the new subsidiary, with Target shareholders receiving stock in Acquiring (the parent) and perhaps other consideration. After the forward triangular merger is consummated, the assets and liabilities of the former Target are held in the subsidiary.

If a forward triangular merger is desired, the tax law imposes additional requirements on the transaction relative to a straight merger. The most significant is the requirement that the subsidiary acquire *substantially* all of Target assets.[186]

An S Corporation may be the surviving entity in a merger transaction. If a C Corporation is the merged entity, the surviving S Corporation will succeed to the earnings and profits of the C Corporation. The existence of earnings and profits creates some concerns for the S Corporation, including a new “tier” from which distributions may be made and the risk of imposition of the penalty tax on excess passive earnings (which penalty may terminate the S election if it applies for three consecutive years).

Any assets transferred by a merged C Corporation to a surviving S Corporation will be subject to the §1374 built-in-gains tax. It is, of course, also necessary to ensure that the shareholders admitted by the merger are qualified to be S Corporation owners and that the 100-shareholder limit has not been exceeded. Finally, any debt of the merged entity should be evaluated to ensure that it could not be reclassified as equity under §385 principles and possibly terminate the S election due to a prohibited second class of stock.

Type B

A Type B reorganization involves the acquisition of stock representing control of Target solely in exchange for voting stock of Acquiring.

Control is defined in §368(c) to be at least 80 percent of the total combined voting power of all classes entitled to vote and 80 percent of the number of all other classes of stock.

[186] Section 368(a)(2)(D). The statute does not define what is meant by substantially all of Target's assets, although this term is also used in Type C reorganizations. However, the IRS will not issue a favorable advance ruling unless the acquiring entity acquires at least 70 percent of the gross assets and 90 percent of net assets. See Revenue Procedure 77-37, 1977-2 C.B. 568.

One aspect of a Type B reorganization is that when §368(a)(1)(B) says solely in exchange for voting stock, it actually means solely. In most other nonrecognition provisions, solely simply means that no gain will be recognized if the only consideration is qualified consideration. If consideration other than that specified by the statute is received, it is classified as boot and gain is recognized to the extent of the boot received.

Type C reorganizations allow a limited amount of boot consideration, and Type A allows even more boot. However, Type B allows no boot at all. The only exception is that cash may be transferred in exchange for fractional shares provided the cash transfer is only for the purpose of rounding-off shares.

The solely-for-voting-stock requirement may be unacceptable if Acquiring is concerned that voting stock in the hands of a concentrated group may exert significant control over Acquiring. Also, the requirement that 80 percent of Target's stock must be acquired means that a very high percentage of Target shareholders must be willing to participate in the acquisition by accepting the offer made by Acquiring. In contrast, a merger may be approved with a majority vote (although a *supermajority* of two-thirds may be required in certain cases).

One reason to employ a B reorganization is that it is the only form of reorganization in which Acquiring bargains with shareholders of the Target. In a Type A or Type C, which are both asset acquisitions, Acquiring negotiates with management of the Target. If management is hostile to the reorganization plan, a share-for-share exchange may be the only means of consummating the acquisition. Of course, in closely held corporations, there is often no distinction between ownership and control.

For tax years beginning after December 31, 1996, an Acquiring S corporation could use a Type B acquisition without liquidating the acquired entity. If Target is a C corporation, the Acquiring S corporation could be the parent in an affiliated group provided it did not join the C corporation subsidiary in filing a consolidated return. If Target is an S corporation, the Acquiring S corporation must both acquire 100 percent of the subsidiary and make a §1361(b)(3)(B) election to qualify the S subsidiary.

A Type B may be preferable to a Type A if it will be difficult or costly to comply with state merger statutes (Type B need not comply with state law). For example, there is no need for shareholder approval or dissenters' appraisal rights in a Type B reorganization. (Because Target survives in a Type B, dissenters may continue to hold their Target shares after the reorganization. In contrast, a merger or a Type C reorganization involves the dissolution of Target, and dissenters cannot be forced to accept Acquiring stock that they do not want.) Further, a Type B has no statutory tax law requirement that substantially all of the assets of Target be acquired, such as exists in a Type C or a forward triangular merger, which may make a Type B more flexible when Target has unwanted assets.

Type B reorganizations do not invoke the tax attribute provisions of §381. Because Target remains in existence, all tax attributes also stay in existence. However, the ability to utilize tax attributes of an acquired Target may be limited.[187]

[187] See §§269, 382,383, and 384 for limitations on utilization of tax attributes.

Although voting stock must be the only consideration in a Type B reorganization, the stock may be common or preferred. Because the statute refers to a payment to acquire stock representing control of Target, consideration other than stock may be transferred to acquire securities (that is, debt) of Target or to compensate shareholders of Target for bona fide leases or for services.

Type C

A Type C reorganization is the acquisition of substantially all of the assets of Target in exchange for voting stock of Acquiring.

The meaning of *substantially all* of the assets of Target is the same as discussed above in connection with forward triangular mergers. For advance ruling purposes, the IRS requires that at least 90 percent of net assets and 70 percent of gross assets be acquired.

The solely-for-voting-stock requirement means that Type C reorganizations are less flexible than mergers with respect to consideration. However, as is true in many tax law provisions, the statute does not necessarily mean that *solely* voting stock may be used. There are two exceptions to the solely-for-voting-stock rule:

1. In general, the assumption of liabilities of Target will be ignored in determining whether voting stock is the only consideration.
2. If at least 80 percent of the fair market value of Target corporation property is acquired with voting stock, other (boot) consideration may be used to acquire any remaining property.[188] However, this rule is subject to an important limitation. If any consideration other than voting stock is used, then the assumption of liabilities of Target will be counted as consideration in determining whether 80 percent of the total consideration was voting stock. Boot consideration may be cash, nonvoting stock, notes, and other items other than voting stock.

A Type C reorganization requires that Target distribute all property received from Acquiring as well as any property that was not transferred to Acquiring.[189] Because Target must distribute all assets that it holds, it would generally liquidate as part of the plan of reorganization.

Triangular Structures

Recall from earlier in this chapter that a forward triangular merger involved the formation of a new subsidiary (an existing subsidiary could also be used) by Acquiring, followed by a merger of Target into the new subsidiary. Such a merger is called *triangular* because of the existence of three parties. The *forward* refers to the merger of Target into Acquiring.

A reverse triangular merger is similar to a forward triangular, except that the subsidiary (generally newly formed) is merged into Target. At the completion of a reverse triangular merger, Target survives as a subsidiary of Acquiring (the subsidiary is merged out of existence). The end-result resembles a Type B reorganization.

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[188] Section 368(a)(2)(B).

[189] Section 368(a)(2)(G). The IRS may waive the distribution requirement in appropriate circumstances [§368(a)(2)(G)(i)]. In Revenue Procedure 89-50, 1989-2 C.B. 631, the IRS lists certain conditions under which it will issue a favorable advance ruling that the §368(a)(2)(G) distribution requirement has been satisfied.

A reverse triangular merger resembles a stock acquisition because Target remains in existence and is controlled by Acquiring. Thus, a reverse triangular merger would be an appropriate option when the continued existence of Target is important.

A reverse triangular merger has certain advantages over a Type B reorganization. The major disadvantage of a Type B reorganization is the inflexible consideration. Acquiring may find itself with dissenting shareholders who survive as minority shareholders in Target. Such shareholders may not be offered cash for their shares as part of the plan of reorganization without violating the solely-for-voting-stock consideration requirement.

Because of the similarity of a reverse triangular merger to a Type B reorganization, Congress recognized the need to subject reverse triangular mergers to more stringent requirements than those applicable to a straight merger. Without additional requirements, the reverse triangular merger would allow the taxpayer to create the economic result of a Type B reorganization without the need to satisfy the stringent requirements of such an acquisition.

Section 368(a)(2)(E) and Regulations §1.368-2(j) describe the additional requirements applicable to a reverse triangular merger. These include the following:

- Target shareholders must transfer stock representing control of the Target. Control is defined in §368(c), which is the same provision applicable to Type B reorganizations. Thus, the 80 percent test of a Type B reorganization, and not the continuity of interest requirements applicable to mergers in general, applies to a reverse triangular merger.

- After the merger, Target must hold substantially all of (i) Target's assets, and (ii) the assets of the merged subsidiary. However, any assets of the merged subsidiary that were acquired from the parent Acquiring Corporation for purposes of supplying the consideration for the acquisition are ignored. That is, if the Acquiring parent transfers stock and cash to the subsidiary, and the stock and cash are then used as consideration provided to Target shareholders, the stock and cash are disregarded in determining whether Target holds substantially all of the merged subsidiary's assets. Thus, this requirement basically is the same as that applicable to Type C acquisitions and forward triangular mergers.

- Voting stock consideration must be used to acquire stock representing control of Target (assumption of Target liabilities does not violate the voting stock consideration requirement and is treated as a contribution to the capital of Target by the Acquiring parent). However, other consideration, such as cash, may be used to acquire stock of Target in excess of the 80 percent control requirement. This allows Acquiring to pay cash to dissenters provided at least 80 percent of Target is acquired for voting stock. Thus, the reverse triangular merger is more flexible than the Type B in this respect. Target may also redeem shares of dissenters before the reorganization. Shares redeemed will not be counted in determining if Acquiring satisfies the control requirement. However, the assets used to redeem the dissenters will be counted in determining whether substantially all of Target assets are held after the reorganization.

- Although the ability to use consideration other than voting stock is more flexible than the consideration requirements of a Type B reorganization, a reverse triangular merger requires that control be acquired in the reorganization itself. That is, Target shareholders

must surrender stock representing 80 percent control in the reorganization. In this respect, a reverse triangular merger is less flexible than a Type B, which only requires that 80 percent control exist after the acquisition.

Nontaxable Divisions of a Corporation

Chapter 4 noted that it is not possible to distribute appreciated property from a corporation to a shareholder without recognition of gain by the corporation. However, it is possible for a corporation to distribute stock of a controlled corporation without any gain recognition. The shareholder who receives such stock may also avoid any gain recognition. Such divisive reorganizations, so named because they involve the division of a single corporation, have become quite popular as the last opportunity to distribute appreciated property (in this case stock) without any gain recognition.

Corporate divisions take one of the following three forms:[190]

1. A *spin-off*, in which stock is distributed *pro rata* to all shareholders , and no stock in the distributing corporation is surrendered. A spin-off resembles a dividend distribution.
2. A *split-off*, in which stock is distributed in exchange for the surrender of shares in the distributing corporation. A split-off resembles a distribution in redemption of stock.
3. A *split-up*, in which stock is distributed in exchange for the surrender of all of the shares of stock held by the distributee. A split-up resembles a distribution in liquidation of the distributing corporation. This structure is useful if co-owners can no longer work together and seek to divide the business into separate operating units.

Each of the three divisive reorganizations can be tax-free to both the distributing corporation and the distributee shareholder if the requirements of §355 are met. Basically, the distributed stock must represent control (80 percent of voting rights and of the number of all nonvoting classes) of a subsidiary and must not be a “device” for the tax-free distribution of earnings and profits.[191]

Both the distributing corporation, and the controlled corporation whose stock is distributed, must be engaged in the conduct of an active trade or business immediately after the divisive reorganization. An active trade or business is one that has been conducted for five years before the date of distribution, and which was not acquired in a taxable transaction.[192]

The ability to divide an existing corporation without recognition of gain helps to mitigate any disadvantage of the corporate form created by the difficulties in distributing appreciated property without adverse tax consequences to the entity and its owners.

Mergers and Divisions of Partnerships

When two or more partnerships are merged into one, the surviving partnership is treated as a continuation of that partnership whose partners own more than 50 percent of the capital and

[190] Section 368(a)(1)(D).
[191] Section 355(a)(1).
[192] Section 355(b).

profits of the surviving partnership.[193] Any partnership which is not treated as the survivor is terminated by the merger.

Example 5-1

The XY and the TZ partnerships are merged. Partners in the XY partnership acquire 75 percent of the capital and profits interests in the surviving partnership. The surviving partnership is treated as a continuation of the XY partnership. The TZ partnership is terminated by the merger.

The form of a partnership merger may be "assets up" or "assets over." The term "assets up" means that the terminated partnership transfers its assets "up" to its partners in liquidation of their partnership interests. The partners of the terminated partnership are then deemed to transfer the assets to the surviving partnership. In the "assets-over" form, the terminated partnership is deemed to transfer its assets "over" to the surviving partnership in exchange for an interest in the surviving partnership. The terminated partnership then liquidates and distributes interests in the surviving partnership to its owners.

The assets-over form applies for tax purposes unless the merger follows the assets-up form for state law purposes. Similar provisions, in which assets-over dominates as the default classification, apply for partnership divisions.

A merger may create significant accounting problems when the partnerships use different methods of accounting or report on different tax years.

If a single partnership is divided into two or more partnerships, any resulting partnership which includes members who owned more than 50 percent of the capital and profits in the old partnership shall be treated as a continuation of the old partnership.[194] The continuing partnership uses the same tax year and method of accounting of the old partnership.

Example 5-2

The TZXY partnership is divided into the TZ and the XY partnerships. The TZ partnership includes partners who owned 60 percent of the capital and profits interests in the TZXY partnership. The TZ partnership will be treated as a continuation of the TZXY partnership. The surviving XY partnership is a new entity and not a continuation of the old entity.

If none of the resulting partnerships meets the more than 50 percent test, then the old partnership is treated as terminated for tax purposes.

Conversion of a Corporation to a Partnership

Overview

Because it offers both liability protection to all owners, regardless of their participation in the business, and the tax flexibility of the partnership form, the LLC form is becoming the entity of

[193] Section 708(b)(2)(A).
[194] Section 708 (b)(2)(B).

choice for many new businesses. Some owners of businesses that are presently in the corporate form may be interested in converting to the LLC form, which is taxed as a partnership. However, the problem with such a conversion is that it will involve a taxable liquidation of the corporation. For this reason a change out of the corporate form into a partnership-taxed form is typically not recommended if there is substantial appreciation in the business assets.[195]

There are four basic ways of converting a business or investment operated in corporate form to a partnership:

1. A liquidation of the corporation with a distribution of all assets to the shareholder(s), with the assets then contributed to a partnership.
2. A transfer, by each shareholder, of all of the corporate stock to the partnership, followed by a liquidation of the corporation. The partnership then acquires all corporate assets as a result of the liquidation.
3. A transfer of assets by the corporation to a partnership, followed by a distribution of the partnership interest to the shareholders in liquidation of the corporation.
4. A transfer of assets by the corporation to a partnership, followed by a continuation of the corporation. The corporation will hold an interest in the partnership rather than direct ownership of its assets. This alternative is different from the first three because the corporate existence continues.

The sections that follow compare the tax consequences of the alternatives. The first establishes the consequences of a corporate liquidation. Once the tax effect of a corporate liquidation is established, the discussion of the other alternatives becomes easier to understand.

Liquidation of Corporation, Followed by Contribution of Assets (Alternative 1)

The distribution of assets by a corporation in complete liquidation will be treated as a deemed sale of the assets to the distributee shareholders at fair market value.[196] Generally, both gains and losses are recognized from the liquidation.[197]

If the corporation is a regular C corporation, the distribution will often result in two levels of tax. If the liquidating corporation is an S corporation, there may be only one level of tax, but the distribution of corporate assets will be a taxable transaction. The same provisions (found in Subchapter C) apply to both C and S corporations. The tax treatment of the liquidation is as follows:

- Per §336, the liquidated corporation will recognize gain and loss on all assets. The corporation recognizes gain or loss measured by the difference between the fair market value of corporate property and the basis of such property to the corporation. If the

[195] This decision should always be made in conjunction with the advice of an attorney. It is possible that the shift under state law to the LLC form could result in a different legal exposure for the business. If the corporation is eligible and pass-through treatment is desired, conversion to an S may be a simpler and less costly method.
[196] Section 336(a).
[197] In contrast, when a corporation distributes assets but does not liquidate, §311(b) requires that any inherent gain be recognized but §311(a) disallows recognition of any loss.

shareholder assumes a liability or takes property subject to a liability,[198] fair market value cannot be less than the amount of the liability. The character of any gains and losses as ordinary, capital, or §1231 is determined as if the assets had been sold to the shareholders.

Because the entity "dies" with the liquidation, all tax attributes disappear.[199] However, attributes are available to the corporation when filing its final income tax return. Thus, if the entity has unused capital loss carryforwards, and related items, it is important to plan for the use of the carryforwards in the final income tax return.

- Per §331, the receipt of a distribution of money or property in cancellation of the shares of the liquidated corporation is a sale or exchange transaction for the shareholder. Thus, the shareholder recognizes a gain or loss measured by the difference between the fair market value of property received and the basis of the stock in the liquidated corporation.[200]

  The shareholder's gain or loss will almost always be capital in nature, because the stock would, in almost all cases, be a capital asset to the shareholder. The transaction is treated as an exchange of property for stock regardless of the existence of earnings and profits. This means that the liquidation method can be used to bail out corporate profits at capital gains rates.

  The long-term or short-term nature of the gain or loss would depend on whether the more-than-one-year-holding-period requirement was satisfied. Gains may be eligible for the exclusion for qualified small business stock.[201] Losses may be eligible for ordinary loss treatment under §1244.

  Because the shareholders have received all property in a fully taxable transaction, the basis of the property received is its fair market value as of the date of distribution.[202] The holding period would begin on the date of the distribution.

Transfer of Stock Followed by Liquidation of Corporation (Alternative 2)

This alternative has the same tax result as the first alternative. The difference is that there is only one transfer of asset title, which occurs when the corporation is liquidated. (That is, there is no need to transfer the assets to the partnership after the liquidation because the partnership is the owner of the stock at the time of the liquidation.)

The tax effects are the same because the transfer of stock to the partnership is tax-free under §721. The former shareholders of the corporation are now partners of a partnership with a basis in their partnership interests equal to the basis of their former stockholdings.[203] Section 704(c) will require that any gain attributable to the contributed stock be allocated to the contributing

[198] Section 335(b).
[199] See §381(c) for a list of corporate tax attributes that would disappear with the liquidation.
[200] Section 331(a).
[201] Section 1202.
[202] Section 334(a).
[203] Section 722.

partner. Thus, when the corporation is liquidated and the partnership recognizes gain,[204] that gain must be allocated among the partners to reflect the amount of pre-contribution gain or loss related to each partner. This should produce the same result as in Alternative 1 above.

The partnership's basis in the corporate stock will equal each of the former shareholders' bases.[205] When the corporation is liquidated, the partnership will acquire a fair market value basis in each of the assets received in the liquidation.[206] This result is again the same as in Alternative 1.

Because a partnership may not own stock in an S corporation, a transfer of S Corporation stock to a partnership will terminate the S election. However, an immediate liquidation of the entity should avoid the need to file a short period return as an S corporation and another return as a C corporation.

Asset Transfer by the Corporation, Followed by Distribution of the Interest (Alternative 3)

If the corporation, be it an S or a C corporation, transfers assets to a partnership in exchange for an interest in the partnership, the transfer will be tax-free under §721(a). The partnership will have a carryover basis in the assets of the corporation under §723. The corporation's basis in the partnership interest will be the same as the basis of the assets transferred.[207]

If the corporation distributes the partnership interest in liquidation of the corporation, the tax result is similar to that described in Alternative 2. The corporation recognizes gain or loss equal to the difference between the fair market value and tax basis of the partnership interest.[208] The shareholder(s) recognize a capital gain or loss equal to the difference between the amount realized from the liquidation, which may be reduced by a corporate-level tax, and the basis of their stock.[209] The partnership interest acquires a fair market value basis to the distributee shareholders.[210]

When compared to a distribution of assets in liquidation of the corporation, followed by a transfer of the assets to a partnership, the tax results to the corporation and the shareholders initially appear to be identical. However, when the assets are first distributed to the shareholders, such assets acquire a fair market value basis which then carries over to the partnership on the subsequent contribution. In contrast, if the corporation first transfers the assets to the partnership and then liquidates, the partnership's basis in the assets is the same as in the corporation. That is, there is no adjustment to fair market value. In both cases, the partnership interest has a basis equal to its fair market value.

The disparity in the basis of the partnership's assets may be corrected if the partnership has a §754 election in effect. This election would allow the shareholders of the corporation to adjust the basis of their share of the assets of the partnership so that such basis would equal the basis of

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[204] See §331(a).
[205] Section 722.
[206] Section 334(a).
[207] Section 722.
[208] Section 336(a).
[209] Section 331(a).
[210] Section 334(a).

the partnership interest.[211] If the transfer is to a partnership that has just been created by the shareholders, the tax practitioner should generally advise that a §754 election be made on the first return.

Before making or advising a §754 election, one must determine the costs and benefits of such an election. Once made, the election is binding on all future tax years unless the IRS permits a revocation of the election. The election may result in both positive and negative adjustments to the basis of assets. For example, if the corporation described in this section had a basis in the assets in excess of their fair market value, the election would result in a reduction in the partnership's asset basis. Even if the overall adjustment is positive, the allocation of the adjustment may not be favorable, such as when the increase is allocated to nondepreciable assets. The election also generally requires additional recordkeeping by the partnership.

Asset Transfer Followed by Continuation of Corporation (Alternative 4)

If the corporation, be it an S or a C corporation, transfers assets to a partnership in exchange for an interest in the partnership, the transfer will be tax-free under §721(a). The partnership will have a carryover basis in the assets of the corporation under §723. The corporation's basis in the partnership interest will be the same as the basis of the assets transferred.[212]

If the corporation does not liquidate, the inherent gain or loss in the partnership interest is not triggered on the corporate tax return. Also, corporate tax attributes survive. The corporation then continues in existence as a partner in the partnership. This structure may be desirable to defer the taxable liquidation of the entity.

A transfer of assets to a new partnership followed by a continuation of the corporate existence may be used to avoid corporate-level gain on post-transfer appreciation in the assets. If the assets are held in a C Corporation, appreciation will eventually be subject to two levels of tax, either when the assets are sold or when they are distributed to the shareholders. Converting the C Corporation into an S Corporation will not avoid two levels of tax for any gains realized within the ten-year recognition period for the built-in-gains tax and may not avoid two levels of tax even for post-conversion appreciation.[213]

If a C Corporation transfers assets to a partnership in exchange for a general partnership interest, and if the shareholders of the corporation transfer property in exchange for limited partnership interests in the same partnership, the partnership agreement may allocate much of the post-transfer appreciation to the shareholders in their individual capacities. Thus, post-transfer appreciation may largely escape the corporate-level tax. Any pre-transfer appreciation must be allocated to the corporation under the principles of §704(c). Post-transfer appreciation may be

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[211] Section 743 is applicable to transfers of an interest in a partnership. In the context of this example, the adjustment occurs because the shareholders are deemed to have purchased the interest from the corporation. The purchase of the interest would result in a §743 adjustment if the partnership has previously made a §754 election or if the election is made by the due date of the partnership's return for the year of the transfer.

[212] Section 722.

[213] Section 1374 provides the rules for the built-in-gains tax. If the taxpayer can prove the amount of any net unrealized built-in gains as of the conversion date [see §1374(d)(1)], then post-conversion appreciation will only be subject to one level of tax. However, a costly appraisal may be required to distinguish pre-conversion gains from post-conversion gains. Also, the S election will immediately trigger a LIFO recapture tax if LIFO inventories are maintained; such tax is payable over four years. See §1363(d).

allocated by agreement subject to the requirement of §704(b).[214] If the corporation has substantial non-tax reasons for establishing a partnership to continue its business activities, the continued existence of the corporation will defer the corporate-level gain.

Restructurings Involving Disregarded Entities

There are two types of disregarded entities that tax planners will commonly encounter—a single-member LLC (SMLLC) and a qualified subchapter S subsidiary (QSub). A SMLLC is organized as an LLC under state law but has only one owner. Under the classification rules of Regs. Sec. 301.7701-3, it is, by default, a disregarded entity. A QSub is a domestic corporation that is wholly owned by an S corporation and for which the S corporation has made an election to treat the entity as a QSub. All assets, liabilities, and items of income and deduction are treated as those of the parent S corporation, and the QSub is disregarded as an entity separate from its owner for federal income tax purposes.[215]

State statutes permit mergers of LLCs and corporations, so that an SMLLC may be merged into a state-law corporation or a state-law corporation may be merged into a SMLLC. Because a QSub is a state law corporation that is simply disregarded for federal income tax (and perhaps state income tax) purposes, mergers involving Qsubs are also possible. The question is, since both SMLLCs and QSubs are disregarded for tax purposes, how does one treat a merger involving a disregarded entity?

Proposed regulations issued on November 15, 2001, permit a merger of a target corporation into a disregarded entity to be treated as a merger of the target into the owner of the disregarded entity. This guidance was issued in temporary form effective January 24, 2003, and in the final regulations effective January 23, 2006.[216] The regulations require that the transaction be treated as a merger of all of the assets and liabilities of one entity into another. Thus, the regulations create new definitions—a *combining entity* is an entity involved in the merger that is not a disregarded entity. A *combining unit* is a combining entity and all of its disregarded entities.

To qualify as a merger transaction, all of the assets and liabilities of a combining unit must be transferred. Thus, if a corporation owns an SMLLC, a merger of the SMLLC into another entity cannot qualify because the combining unit is the SMLLC and its corporate owner, and only a portion of that combining unit has been transferred. In contrast, a merger of a target corporation into a SMLLC owned by another corporation can qualify if the target corporation is a combining unit. The merger of the target into the SMLLC will be treated as a merger into the corporate owner of the SMLLC.

The acquisition of an interest in a SMLLC is treated, under Rev. Rul. 99-5, as the purchase of an undivided share of the assets of the LLC. Thus, the sale of, say, 30 percent of the interests in a SMLLC is treated as a sale of 30 percent of the assets of the LLC. A less favorable result used to occur when a 30 percent interest in a QSub is sold.

If the parent S corporation's 100 percent ownership is terminated, the QSub then becomes a separate entity for tax purposes. The loss of disregarded entity status creates the fiction that the

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[214] Section 704(b) and 704(c) allocations are discussed in detail in Chapter 3.
[215] Section 1361(b)(3).
[216] Regs. Sec. 1.368-2(b)(1)(i).

QSub has acquired all of its assets and liabilities from the parent in exchange for the QSub's stock immediately before its status as a QSub was terminated. Because an S corporation cannot have a corporation as a shareholder, the QSub becomes a C corporation if the parent S corporation continues to own any of its shares.

Following enactment of the 1996 Tax Act, which gave birth to the QSub, Treasury officials indicated their intent to apply step transaction principles to formations and terminations of QSubs, and proposed regulations issued on April 22, 1998, formally announced this intent. Despite significant criticism from the practitioner community, final regulations were issued on January 25, 2000, applying step transaction principles to QSub elections and terminations.

Until the passage of the Small Business and Work Opportunity Act of 2007 (2007 Act), the application of the step transaction doctrine resulted in unintended tax liabilities to many S corporations that sold more than 20 percent, but less than 100 percent, of the stock of the QSub. The result was a deemed transfer of assets to a new corporation immediately before the stock sale, which failed to be a tax-free transaction under Section 351 because the parent S corporation did not control the new entity immediately after the transfer. Although the parent owned 100 percent of the QSub at the moment of the deemed creation of a new entity, control was lost since the stock sale that gave rise to the QSub termination was treated as interdependent with the asset transfer. The result was that the parent S corporation had to recognize 100 percent of any gain inherent in the QSub assets, although less than 100 percent of the stock was sold. The parent also had to report the actual sale of the stock and recognize any gain on that sale.

Section 1361(b)(3)(C) provides that, upon termination of QSub status, the QSub is converted from a disregarded entity to a new corporation. This new corporation is deemed to receive a transfer of all assets and liabilities of the QSub from the parent S corporation in exchange for stock of the new corporation. Section 351(a) provides for no recognition of gain or loss when property is transferred to a corporation solely in exchange for stock, provided the transferors are in control of the corporation immediately following the exchange. Control is defined in Section 368(c) as 80 percent of the voting power and 80 percent of the number of all nonvoting classes of stock in the transferee corporation. Where a transferor controls the corporation at the time of the transfer, but has a binding agreement to transfer stock to a party who is not a transferor, the step transaction doctrine has been applied to deny Section 351 relief to the transferor.[217] The final Section 1361 regulations conclude that step transaction principles applied to the statutory fiction created by a QSub termination, and thus deny Section 351 relief when more than 20 percent of the stock in the QSub is sold.[218] The result is that all of the inherent gain in assets owned by the QSub is recognized when more than 20 percent of the entity is sold.

These regulations have now been superseded by the 2007 Act. The new law provides that where the sale of stock of a QSub results in the termination of a QSub election, the sale is treated as a sale of an undivided interest in the assets of the QSub (based on the percentage of the stock sold) followed by a deemed transfer to the QSub in a transaction to which Section 351 applies. Thus, in the example in the regulations, the S corporation will be treated as selling a 21 percent interest in all the assets of the QSub to the unrelated party, followed by a transfer of all the assets to a

[217] See *May Broadcasting Co.*, 200 F.2d 852 (8th Cir. 1953), *Intermountain Lumber Co.*, 65 TC 1025 (1976), and Rev. Rul. 79-70, 1979-1 CB 144, as examples.
[218] Regs. Section 1.1361-5(b)(3), *Example 1*.

new corporation in a transaction to which Section 351 applies. Thus, the S corporation will recognize 21 percent of the gain or loss in the assets of the QSub. The provision is effective for taxable years beginning after December 31, 2006.

Case Study 5-1: Acquisition of Business Assets

Facts

Target is a business owned equally by four individuals. The current balance sheet appears as follows:

	Fair Market Value	Adjusted Tax Basis
Cash	$30,000	$30,000
Inventories	170,000	100,000
Equipment	140,000	20,000
Real property	300,000	130,000
Totals	$640,000	$280,000

The basis of each owner's interest is $70,000. The equipment has $120,000 of potential §1245 depreciation recapture; there is no recapture potential for the real property although $70,000 of straight-line depreciation has been claimed.

Acquor Industries has offered to purchase all of the assets of Target. Acquor is willing to structure the deal to suit the tax objectives of the owners of Target.

Target may be a C corporation, an S corporation, or an LLC.

Compare the consequences of the proposed acquisition assuming that

1. Acquor will pay $800,000 cash to purchase the *assets* of Target.
2. Acquor will use $800,000 of Acquor stock to acquire the assets of Target.

Discussion

If Acquor uses cash to acquire the assets of Target, the business will have made a taxable disposition of its assets. First, consider the effects of a cash acquisition to the entity and to its owners. Here, the purchase price suggests the existence of unrecorded goodwill in Target's business. The excess of the purchase price ($800,000) over the fair market value of identifiable assets ($640,000), or $160,000, would be recorded as goodwill.

The effects of a taxable purchase of assets (ignoring state taxes) would be as follows for each of the possible entity types:

1. *Target is a C corporation*—Target will recognize $520,000 of gain from the asset sale. This gain will be taxed at a flat 34 percent tax rate,[219] and Target will pay $176,800 of tax. Target will then have $623,200 available to distribute to its four shareholders. Because Target has ceased active business operations, it will liquidate and distribute the cash to the four shareholders, with each shareholder receiving $155,800. Each

[219] C corporation income of $335,000 or greater, but not in excess of $10 million, is taxed at a flat 34 percent.

shareholder will report a capital gain of $85,800, and will pay a capital gains tax of $12,870 (at an assumed 15 percent rate). The net effect is that each shareholder will receive $142,930 in exchange for his or her ownership interest. Because each interest represented $200,000 of net asset value, $57,070 of taxes is assessed against each of the four interests. Acquor will have an $800,000 tax basis in the acquired assets, which basis will be allocated among individual assets using the allocation provisions of §1060.

2. *Target is an S corporation*—Target will again recognize $520,000 of gain from the asset sale. If we assume that Target is not subject to the built-in-gains tax, Target will not pay any tax on this gain. Instead, the gain will flow through to the four shareholders, retaining its character. The gain from the sale of the inventory ($70,000) will be ordinary income as will the gain attributable to the equipment ($120,000). The remaining gain relates to the real property and the goodwill. The $170,000 gain related to the real property should be §1231 gain and the $160,000 related to goodwill will be capital gain. However, $70,000 of gain will be taxed at 25 percent as "unrecaptured §1250 gain." The flow-through of gain will increase the basis of each shareholder's stock to $200,000, so that the distribution in liquidation will not create any further gain. If each shareholder is in a 35 percent tax bracket for ordinary income and a 15 percent bracket for both capital and §1231 gains, the total tax paid will be $123,000 [(.35 × $190,000) + (.25 × $70,000) + (.15 × $260,000)]. Each shareholder will net $169,250. Acquor will have an $800,000 tax basis in the acquired assets, which basis will be allocated among individual assets using the allocation provisions of §1060.

3. *Target is an LLC*—The answer will be exactly the same as if Target were an S corporation, including the effect on the entity, the owners, and Acquor.

If Acquor uses its stock as consideration, *and if Target is a C corporation or an S corporation*, the acquisition may be tax-free if it qualifies as a merger (Target is merged into Acquor), a forward triangular merger (Target is merged into a subsidiary of Acquor, but Acquor stock is used as the consideration), or a "Type C" acquisition (Acquor uses its voting stock to acquire substantially all of Target's assets). If Target is an LLC, the acquisition may not qualify for tax-free treatment under §368(a)(1), except as noted in the discussion below. The effect of a stock acquisition on each of the parties is as follows:

1. *Target is a C corporation*—Target will recognize no gain from the exchange of its assets. Target will function as a conduit because it will receive Acquor stock and immediately distribute that stock to its four shareholders. Target shareholders will recognize no gain from receipt of Acquor stock. Each shareholder's basis in the Acquor stock received will be $70,000. Acquor's basis in the assets acquired will be $280,000. The basis of each asset will be unchanged and there will be no allocation to goodwill. Section 1060 allocation principles will not apply because the asset basis is not determined by reference to purchase consideration paid. Tax attributes of Target, as listed in §381(c), will survive with Acquor. If Acquor is an S corporation, it will have net unrealized built-in gains of $520,000 related to the assets acquired from the Target C corporation.

2. *Target is an S corporation*—The tax treatment of both Target and Target shareholders will be the same as if Target were a C corporation. The answer will be the same for

Acquor with the exception of the potential for a built-in-gains tax if Acquor is an S corporation.

3. *Target is an LLC*—Target will recognize $520,000 of gain from the asset sale. Target will not pay any tax on this gain. Instead, the gain will flow through to the four members, retaining its character. The gain from the sale of the inventory ($70,000) will be ordinary income as will the gain attributable to the equipment ($120,000). The remaining gain relates to the real property and the goodwill. The $170,000 gain related to the real property should be §1231 gain and the $160,000 related to goodwill will be capital gain. A portion of the §1231 gain, $70,000, will be unrecaptured §1250 gain. The flow-through gain will increase the basis of each member's interest to $200,000, so that the distribution in liquidation will not create any further gain. If each member is in a 35 percent tax bracket for ordinary income and a 15 percent bracket for both capital and §1231 gains, the total tax paid will be $123,000 [(.35 × $190,000) + (.25 × $70,000) + (.15 × $260,000)]. Each member will net $169,250. Acquor will have an $800,000 tax basis in the acquired assets, which basis will be allocated among individual assets using the allocation provisions of §1060.

Of course, it would be foolish for LLC members to agree to receive stock if the transaction is fully taxable, unless the members' first investment choice is Acquor stock. If the transaction is fully taxable, Target members may prefer a cash sale. However, if Target members are willing to accept Acquor stock, they should consider changing the entity form to a corporation to permit a tax-free acquisition. This may be done in one of the following two ways:

1. Liquidate Target and have each member transfer assets to a new corporation.
2. Using the election provisions of Regulations §301.7701-3(c), file an affirmative election to treat Target as an association for tax purposes. This alternative avoids the need to actually create a new corporation.

Case Study 5-2: Acquisition of Interests in a Business

Facts

Target is a business owned equally by four individuals. The current balance sheet appears as follows:

	Fair Market Value	Adjusted Tax Basis
Cash	$30,000	$30,000
Inventories	170,000	100,000
Equipment	140,000	20,000
Real property	300,000	130,000
Totals	$640,000	$280,000

The basis of each owner's interest is $70,000. The equipment has $120,000 of potential §1245 depreciation recapture; there is no recapture potential for the real property although $70,000 of straight-line depreciation has been claimed.

Acquor Industries has offered to purchase all of the interests of the owners of Target. Acquor is willing to structure the deal to suit the tax objectives of the owners of Target.

Target may be a C corporation, an S corporation, or an LLC.

Compare the consequences of the proposed acquisition assuming that

1. Acquor will pay $800,000 cash to purchase the interests (stock or membership interests) of the business.
2. Acquor will use $800,000 of Acquor stock to acquire the interests (stock or membership interests) of the business.

Discussion

If Acquor uses cash to acquire the interests of Target's owners, the owners will have made a taxable disposition of the interests. However, the assets of the business have not been acquired and the entity itself will generally have no tax consequences. The facts indicate that the purchase price suggests the existence of unrecorded goodwill in Target's business. The excess of the purchase price ($800,000) over the fair market value of identifiable assets ($640,000), or $160,000, would be goodwill of the business. However, because the assets were not purchased, it is not generally possible, except as noted in the discussion below, to record such goodwill for tax purposes. Of course, because goodwill is a 15-year §197 asset, Acquor would prefer to record the goodwill to obtain future amortization deductions.

The effects of a taxable purchase of ownership interests would be as follows for each of the possible entity types:

1. *Target is a C corporation*—Each shareholder will receive $200,000 in exchange for stock with a basis of $70,000, resulting in a recognized capital gain of $130,000. Target itself will recognize no gain or loss because it has not sold any assets. Acquor will have a basis of $800,000 in the stock it has purchased but the basis of Target assets will remain unchanged at $280,000. Acquor will not be able to record any goodwill for tax purposes because it has not acquired the assets of Target.

   The selling shareholder may be eligible to defer the gain under §1045. The stock that is sold must be qualified small business stock as defined in §1202 that has been held for more than six months. Within 60 days of the sale, the selling shareholder must reinvest in other qualified small business stock. The basis of any replacement stock acquired is reduced by the gain deferred. This deferral is available only if the Target is a C corporation.

   Acquor may treat the stock purchase as if it were an asset purchase, with the result that the basis of the acquired assets will be $800,000 and $160,000 of goodwill will be recorded, if a §338 election is made by Target. Such an election will have a result, to both Target corporation and its shareholders, described in the solution to Case Study 5-1. Because two levels of tax would result from this election, it would be ill-advised for Target to make such an election. If Target were a member of an affiliated group of corporations, a §338(h)(10) election may be advisable to allow Acquor to take a purchase

basis in Target assets. Such an election must be made by the selling and purchasing corporations.

2. *Target is an S corporation*—The answer will be the same as for a Target C corporation. If Acquor is a C corporation, the S election of Target will be terminated because a C corporation is not an eligible shareholder.[220] For tax years beginning after December 31, 1996, Target could continue as an S corporation as a subsidiary of Acquor provided an election is made to treat Target as a qualified subchapter S subsidiary. However, this election will only be available if Acquor is an S corporation. Such an election, which is available only for 100 percent owned subsidiaries, results in the subsidiary's income being reported as a division of the parent S corporation. That is, all income of Target would be included on Acquor's return and Target would not file a separate return.

   If Acquor wants a purchase basis in Target assets, including the ability to record and amortize purchased goodwill, a §338(h)(10) election is available. Final regulations issued under §338(h)(10) allow an S corporation Target to be a party to a §338(h)(10) election (the election generally requires that Target be a member of an affiliated group of corporations so that the seller of the stock is a corporation). Target will be treated as if its assets were sold while Target was still an S corporation. Thus, the gain from the deemed asset sale will flow through to Target shareholders and there will be only one level of tax. Acquor would be treated as if it had purchased Target assets for $800,000. The cost to Target shareholders is that the gain attributable to the equipment and inventory will be reported as ordinary income instead of capital or §1231 gain. Also, $70,000 will be taxed at 25 percent as "unrecaptured §1250 gain." If all Target shareholders are in the 35 percent tax bracket, the election will cost Target shareholders $45,000 ($190,000 taxed at 35 percent rather than 15 percent and $70,000 taxed at 25 percent rather than 15 percent). Because Acquor would benefit from the election (Acquor's basis in Target assets would be $800,000 and it would be able to amortize purchased goodwill), Target shareholders should demand additional consideration to offset the cost of the election. The additional consideration would itself be taxable as capital gains and Target shareholders should request another $52,940 ($45,000/.85) to compensate for the cost of the election.

3. *Target is an LLC*—The purchase of 100 percent of the ownership interests of Target will terminate Target pursuant to §708(b)(1)(A). Target members will each report gain of $130,000. Of that amount, $47,500 will be ordinary income pursuant to §751. Also, $70,000 in total, or $17,500 per member, will be taxed at 25 percent. Section 741 will allow the remaining gain to be capital gain taxed at 15 percent. Target may continue as a one-member LLC. Acquor will be treated as if it purchased the assets of Target and will have an $800,000 basis for tax purposes.

   Let us assume that Acquor purchased only 40 percent of the interests. Acquor's basis in its interest will be purchase cost, but the basis of the assets represented by that interest would not be changed. If the LLC had a §754 election in effect, Acquor could adjust the basis of its share of LLC assets as provided in §755. If Acquor purchased 80 percent of the interests, Target would terminate under §708(b)(1)(B) because there had been a sale of 50 percent or more of its interests. Target will be treated as if it had contributed

[220] Section 1361(b)(1)(B).

membership interests to a new LLC and then distributed the interests of the new LLC in liquidation of Target. Without a §754 election, Acquor would receive no asset basis adjustment.

Case Study 5-3: Division of a Business

Facts

A business, which we will refer to as "Realco," has two divisions, each of which constitutes a separate trade or business that has been operated by Realco for seven years. One division is a construction business and will be called "Construction." The other division is a design business and will be called "Design." The fair market value and tax basis of the total assets held by each division are as follows:

	Fair Market Value	Adjusted Tax Basis
Construction	$3,000,000	$1,780,000
Design	$1,000,000	$760,000

Realco is owned by four individuals, each owning 25 percent of the entity. Robert is a licensed architect who handles virtually all of the operations of Design. Robert has had disputes with the other three owners for the past two years, and all of the parties agree that it is best if Robert took the assets of Design and went his own way. The parties are willing to structure the arrangement to maximize the tax benefits to Robert. None of the shareholders are related within the meaning of §318.

Realco may be a C corporation, an S corporation, or an LLC. Robert's basis in his interest is $400,000.

Discussion

The following discussion will address how Design may be distributed to Robert with the best tax result, assuming that Realco is, in turn, a C corporation, an S corporation, and an LLC.

1. *Realco is a C corporation*—If the assets of Design are distributed in complete redemption of Robert's Realco stock, the tax result is clear. Realco will recognize $240,000 of gain pursuant to §311(b), which treats the corporation as if it sold the distributed assets to Robert at fair market value. Robert will recognize gain of $600,000 ($1 million received minus $400,000 stock basis) and his basis in the distributed assets will be $1,000,000. The gain will qualify as capital gain under §302(b).[221] Realco and Robert could avoid gain recognition if Realco first contributes the assets of Design to a new corporation, which we will call "Newco," in exchange for 100 percent of the stock of Newco. Realco may then distribute the stock of Newco to Robert in exchange for his Realco stock. This transaction should be tax-free to both Newco and Robert because it qualifies as a split-off under §355. Realco is distributing control of Newco, Newco will operate a trade or business after the distribution as will Realco, and both businesses have been in operation for more than five years. There must be a business purpose for the distribution so that the distribution is not a "device" for the distribution of Realco's

[221] Sections 302(b)(2), (b)(3), and (b)(4) would all support exchange (capital gain) treatment for Robert.

earnings and profits. The shareholder dispute will qualify as a business purpose. Robert will have a substituted basis ($400,000) in the Newco shares acquired and Newco's basis in Design assets will be $760,000.[222] Robert's new corporation (Newco) will succeed to the corporate-level tax on Design's assets and Robert individually will defer the gain attributable to his own shares.

2. *Realco is an S corporation*—The result would be similar to that of a C corporation, except that a distribution of Design assets would not result in a corporate tax. However, §311(b) would require the corporation to recognize gain of $240,000, which gain would be allocated equally to the four shareholders, including Robert. Robert's stock basis would then be $460,000, and he would recognize an additional $540,000 of gain when his shares are redeemed (for a total of $600,000, including the flow-through gain). The basis of assets received would again be $1 million. The S corporation could also establish a controlled corporation (that is, Newco) to hold Design assets and to be used to effectuate a split-off. For tax years beginning after December 31, 1996, it is clear that an S corporation may own 80 percent or more of a C corporation (provided the S corporation does not join in the filing of a consolidated return) or 100 percent of a qualified Subchapter S subsidiary (which requires an affirmative election). The stock of the controlled subsidiary (which holds Design assets) could then be distributed in a §355 split-off, with the same result as described for the C corporation situation.

3. *Realco is an LLC*—Because there is no provision for a divisive tax-free reorganization involving an LLC that is taxed as a partnership, the distribution will be taxed under subchapter K. Unless there is a concern with a disproportionate distribution of §751 assets, the distribution of Design assets to Robert will be tax-free pursuant to §731. Robert's basis in distributed assets will be $400,000, the substituted basis of his LLC interest which is terminated with the distribution.[223] The basis will be allocated under the rules of §732(c), first to inventory and unrealized receivables in an amount equal to the LLC's basis in such assets, with any remaining basis allocated to the other distributed assets of the LLC.

Case Study 5-4: Conversion of a Corporation to an LLC

Facts

Conversion Inc., an electing S corporation, is owned equally by four unrelated individuals. The current balance sheet appears as follows:

	Fair Market Value	Adjusted Tax Basis
Cash	$30,000	$30,000
Inventories	170,000	100,000
Equipment	140,000	20,000
Real property	300,000	130,000
Totals	$640,000	$280,000

[222] See §358(a) for Robert's basis and §362(b) for Newco's basis.
[223] Section 732(b).

The basis of each owner's interest is $70,000. The equipment has $120,000 of potential §1245 depreciation recapture; there is no recapture potential for the real property although $70,000 of straight-line depreciation has been claimed.

The owners desire the flexibility of making special allocations of tax items, and they would prefer that Conversion be an LLC. They have inquired as to the tax costs, if any, of changing to the LLC form.

Discussion

Changing the type of entity from an S corporation to an LLC will require a liquidation of the S corporation, with a distribution of assets to the shareholders, followed by a transfer of the assets to a new LLC.

A liquidation of Conversion will be treated as a taxable sale of all assets by the corporation.[224] Gain or loss will be determined as if the assets were sold to the shareholders at fair market value. The result of this deemed sale will be that Conversion Inc. recognizes $70,000 of ordinary income attributable to its inventories, $120,000 of ordinary (§1245) income from the equipment, and $170,000 of §1231 gain from the real property. Of the §1231 gain, $70,000 will be taxed at a 25 percent rate as "unrecaptured §1250 gain."[225] These items will flow through to the shareholders and retain the character of income as determined at the corporate level.[226]

Each of the four shareholders will report one-fourth of the total income ($90,000 each), which will increase the basis of their stock to $160,000. Section 331 will then apply to the liquidating distribution received by the shareholders, and there will be no further gain or loss recognized because the amount of the distribution equals the basis of the shares canceled in liquidation. The shareholders' basis in the distributed property will be fair market value.[227]

An issue that may arise is whether Conversion Inc. has goodwill or going concern value not reflected on its balance sheet. If so, the corporate-level gain will be increased, as will the shareholders' stock basis. Without any built-in-gain exposure, the net effect to the shareholders should be unchanged, mitigating the risk that the IRS would make such an argument. If Conversion had been a C corporation rather than an S corporation, or an S corporation with built-in gains, it might have been necessary to document that goodwill, if it does exist, belongs to the shareholders and not to the corporation.[228]

The transfer of assets to the newly formed LLC will be nontaxable pursuant to §721, although the members will have no realized gain from the transfer because the basis of all assets has been adjusted to fair market value as a result of the S corporation liquidation. Because the basis and fair market value of all assets will be equal, there will be no §704(c) allocations in the new LLC, and the members may agree to allocate items disproportionate to membership interests if the agreement has substantial economic effect.[229]

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[224] Section 336(a).
[225] Note that §1239 does not apply here because the shareholders are unrelated.
[226] Section 1366(b).
[227] Section 334(a).
[228] See *Martin Ice Cream* 11 TC 189(1998) and Norwalk TC Memo 1998-279.
[229] See Chapter 3 for a detailed discussion of both §704(c) and the substantial economic effect test.

The LLC's basis in the assets will equal fair market value (that is, the same basis as those assets had to the contributing members).[230] The members' basis in their LLC interests will be $160,000 each, the same basis as the property contributed to the entity.[231]

Is it wise to change the form of entity? Many advisors would say "no" because the $360,000 inherent gain in Conversion's assets was recognized earlier than would otherwise occur. However, there are three mitigating factors that may lead the owners to choose to change the entity form notwithstanding the early recognition of gain. *First*, the current S corporation form allows the change of form to occur with only one level of tax. If Conversion were currently a C corporation, the answer would almost certainly be not to change the entity form. *Second*, it is likely that the gain from the inventory would be recognized within the short term regardless of the change in form of entity.[232] *Third*, the change in form allows for special allocations, which may create tax savings to offset the costs of the early gain recognition.

Case Study 5-5: Acquisition of Corporate Stock and Section 338

Facts

Joe Wilson is interested in acquiring 100 percent of the stock of Keller Industries in a taxable stock purchase for $5 million. The basis of Keller's assets is $2 million. Keller is owned by Mega Industries. Mega's basis in the Keller stock is also $2 million. Joe wants to acquire Keller's stock rather than its assets because Keller has valuable intangibles that would disappear if the separate existence of Keller disappeared (or if Keller remained as a separate company owned by Mega following an asset purchase, the intangibles would remain with Keller). However, Joe wants the basis of Keller's assets to be adjusted to the $5 million that he intends to pay.

Discussion

Joe's basis in the Keller stock will be the $5 million consideration paid to acquire it—the basis of Keller's assets will not change because Joe has not purchased (except indirectly) the assets.

Section 338(h)(10) may provide a solution to Joe's basis problem. However, Joe will have to form a regular corporation to purchase the stock of Keller. The discussion which follows will review the basics of this election. The terms *Target*, *Old Target*, and *New Target* will be used instead of Keller to be consistent with the language used within §338. It should be understood that Target refers to Keller.

> **Note.** *The election to treat a stock purchase as an asset purchase is available only if the purchaser is a corporation.* Joe could take advantage of this election if he first forms a corporation to be the acquiring entity.

A §338 election generally allows the purchaser of stock to treat the acquisition as a purchase of assets. The deemed asset purchase occurs through a tax fiction in which the Target corporation

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[230] Section 723.
[231] Section 722.
[232] This statement assumes that the inventory would be sold within a reasonable time. Of course, the statement may not be true if the entity uses the LIFO method and does not expect to invade base layers for a long time.

(referred to as *Old Target*) is deemed to sell its assets to a fictitious new entity referred to as *New Target*. The deemed sale occurs at the end of the acquisition date of target's stock, which occurs when the acquiring corporation acquires at least 80 percent of the voting ownership and value of the target corporation. Old Target recognizes gain on the deemed sale under the provisions of §336 and is deemed to liquidate. New Target then acquires a cost basis in the assets deemed to be acquired, with cost determined under a formula that includes the purchase cost of Target stock and the liabilities of Target, including the tax liability created by the election. Tax attributes of Target disappear with the deemed liquidation. This transaction is a fiction for legal purposes, as Target actually remains in existence in accordance with the form of the transaction as a stock purchase.

A §338 election is generally ill-advised after the 1986 Tax Reform Act unless Target has net operating losses that can shield the gain on the deemed asset sale. However, a §338(h)(10) election is commonly used. The §338(h)(10) election requires that the Target be a member, but not the common parent, of an affiliated group. If the parent corporation sells the stock of the Target to another corporation, a §338(h)(10) election is possible.

Without the election, the selling corporation will report a gain or loss from the sale of Target stock. The acquiring corporation will obtain a cost basis in the acquired stock but there will be no change in the basis of target assets. The purchaser could make a §338 election, but the election would trigger a taxable gain on the deemed asset sale.

To avoid two levels of tax, the selling corporation could join with the purchasing corporation in making a §338(h)(10) election. The election will create the following tax fiction: Old Target sells its assets to New Target at the close of the acquisition date and when Old Target is part of the selling corporation. Old Target then liquidates into the parent using §§332 and 337, which allow a subsidiary to be liquidated into the parent without any tax paid by either party.

The result of the election is that the New Target, owned by the purchasing corporation, has a cost basis in its assets. The selling consolidated group reports a gain from the sale of Old Target assets and no gain from the sale of the stock. Old Target tax attributes survive within the selling consolidated group and are not subject to §382 limitations. New Target is a newly formed entity for tax purposes, with no tax attributes.

The §338(h)(10) election permits an asset basis adjustment with only one level of tax. To be eligible for the election, the purchaser of the stock must be a corporation.

The election is made jointly by the purchasing corporation and the selling consolidated group on Form 8023, generally on or before the 15th day of the 9th month after the acquisition month. The principal restriction on the use of a §338(h)(10) election is the requirement that a corporation be used as the acquiring entity.

Chapter 6

Estate Planning Issues

Overview

The choice of a business entity will affect the estate and business succession planning alternatives available to the client. This chapter will review the federal estate and gift tax issues that may affect the choice of an entity. This will be followed by a discussion of business succession planning in the estate context. This chapter will also discuss the use of a charitable remainder trust as a vehicle to dispose of a business interest.

The Unified Transfer Tax System

A tax is imposed on transfers of property during an individual's lifetime and at death if the transfer is not in exchange for full and adequate consideration in money or money's worth. Since the sale of a business to an independent party, as described in the last chapter, involves full consideration, there is typically no tax imposed on those types of transfers. The estate or gift tax is imposed most often on transfers within a family. It should be remembered that transfers to family members, even when some consideration is exchanged, will remain suspect as possible disguised gift transfers subject to tax.

Unified Tax Base and Tax Rates

The transfer tax, whether it is for lifetime transfers or for transfers at death, is imposed using a single tax rate schedule that imposes a higher tax rate on transfers of greater value.[233] The tax is imposed on an annual basis, with gift tax returns due at the same time as an individual's income tax return,[234] but the tax base is determined on a lifetime basis. That is, the tax is imposed on cumulative transfers subject to tax, such that each successive transfer is taxed at the next highest rate of tax.[235] A credit is allowed for taxes imposed on prior transfers included in the tax base so that there is no double tax.[236]

The amount of the unified credit is adjusted to permit an increased share of an estate to pass free of transfer tax. The amount that may be passed free of tax will increase according to the following schedule:

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[233] See §2001(c) for the rate schedule applicable to transfers at death and §2502(a) for application of that same schedule to transfers during life.
[234] Section 6075(b).
[235] Section 2504.
[236] Section 2505.

Year	Estate Exemption Equivalent Amount
2001	$675,000
2002-2003	$1,000,000
2004-2005	$1,500,000
2006-2008	$2,000,000
2009	$3,500,000
2010-2012	$5,000,000*
2010 (optional)	Unlimited

* Spouses are able to transfer unused amounts to surviving spouses by election during this three year period, effectively allowing couples a combined $10,000,000 exemption.

Special Rules for 2010

Note that for 2010 only, the repeal of the estate tax with carryover basis was still an option. For decedents who died during calendar 2010, the executor is allowed to elect out of the new rule system. This election will be made in accordance with guidance provided by the Secretary and will be irrevocable.

Given the reinstatement of the estate tax, but the option of operating under repeal for 2010, professionals will need to determine whether it is more beneficial to operate without an estate tax and only the step-up of $1.3 million to non-spouse recipients and $3 million to spouse recipients or to operate with the 35 percent estate tax rate and have the ability to step-up all property (of course not including income in respect of a decedent) to fair market value.

Also note that while this election is in place for 2010, the ability to elect to unused exclusion amount of a deceased spouse was not effective until 2011.

For those decedents who died after December 31, 2009 and before December 17, 2010, the date of enactment of the Tax Relief Act of 2010, the due date for filing the return under §6018 (estate tax return), including elections required for those returns and paying the tax is not to be earlier than nine months after enactment. This is the case without regard to the election under Act §301(c) (the ability to keep the repeal rules originally set for 2010).

Likewise, a disclaimer of property from the estate under §2518(b), is also allowed this nine month period after enactment. The returns under §2662 related to the generation-skipping tax are also given a nine month filing period.

The deduction for taxes paid to states is allowed after December 31, 2009.

The gift tax exemption equivalent is $1,000,000. Unlike the figures shown for the estate tax, the gift tax exemption will not change.

The maximum transfer tax rate in 2009 was 45 percent. In 2013, the estate tax is scheduled to revert to its pre-2001 Act level. If this occurs, the maximum rate will return to 55 percent.

Effective 2010, the gift tax rate will equal the highest marginal rate for individuals. The purpose of retaining the gift tax and of establishing a gift tax rate equal to the highest income tax rate is to prevent use of gifts to shift income.

Annual Exclusion for Gift Transfers

In 2010, each individual is allowed to transfer as much as $13,000 per year to each donee without incurring a transfer tax. This annual exclusion can be effectively doubled where spouses choose to transfer property to their children. Thus, a husband and wife could give as much as $26,000 each year to each of their children [or to any other donee(s)] without any concern about the transfer tax.[237]

There are several practical issues involved in maximizing the use of the annual exclusion. First, the exclusion is available only for present interests where the donee can currently enjoy the benefits of the gift. For this reason transfers to minors or transfers in trust can require special planning.

Second, if spouses give more than $13,000 to a child during a single year, the nature of the ownership arrangement between the spouses can create special tax concerns. If each spouse owns an undivided share of the gifted property, then $26,000 can be transferred within the annual exclusion because each spouse has gifted no more than $13,000. However, if one spouse owns the entire property interest, the non-owner spouse must sign a consent to treat the gift as made one-half by him or her. This consent is made on the annual gift tax return. This return must be timely filed to make the consent.[238]

The rules also reintegrate the unified credit to be used against estate and gift taxes beginning in 2011. The gift tax rate to be used in calculating the credit will be adjusted to provide for consistency with the revised rules. For 2010, the gift tax exclusion amount maximum was $1,000,000.

For calendar 2010, the rate on the generation-skipping transfer tax under §2641(a) was zero. The generation-skipping rate in 2011 and 2012 is 35 percent.

Lifetime Gifts of Property

Basic Advantage

By gifting property during his lifetime, the decedent reduces the size of both the gross estate and the probate estate. Because gifts are subject to a transfer tax, planning typically centers on two issues: (1) use of the annual exclusion, discussed above, and (2) which property to gift.

Giving Stock in a Closely Held Business

Because the transfer tax is imposed on the value of property transferred, the most appropriate type of property to give away during your lifetime is appreciating property. For example, if stock in a closely held corporation is valued at $1 million today, but is expected to be valued at $4 million at the date of death, then a lifetime transfer will shift $3 million to beneficiaries free of

[237] Section 2503(b) and 2513(a).
[238] Section 2513(b).

any transfer tax.[239] For this reason, using lifetime gifting to transfer business interests to the future heirs can result in significant tax savings.

In the case of a smaller estate, the unified credit may be able to shield the entire estate including the business from the estate tax. If so, then lifetime giving may not be the best alternative. The transfer occurring through the estate will result in a step-up in basis for the heir while a gift will result in a carryover basis. For larger estates, however, gifting interests during the donor's lifetime may result in lower overall taxes even though the basis in the hands of the donee will be carryover basis rather than stepped-up basis.

It should be noted that for gifts that occur within three years of death, the gross estate includes the tax paid on the gift transfer.[240] This three-year rule is designed to prevent a gift transfer, intended to take advantage of the difference in the gift and estate tax bases, when the donor expects death to occur shortly.

Gifts to Minors or in Trust

Individuals frequently decide to transfer property to minors to either fund a specific need, such as college, or to provide a good start in life for the donee. Transfers to trust by a grantor for the beneficial enjoyment of another occur for a variety of reasons, including the lack of capacity of the donee (either age or mental or physical incapacity) and the donee's lack of interest in managing property.

Transfers to trust or to minors can create problems in qualifying for the annual exclusion for gift transfers because the exclusion is available only if the donee has the present right to receive enjoyment from the property.[241]

Qualifying Transfers in Trust for the Annual Gift Exclusion

If the trust terms permit the beneficiary to receive current enjoyment of property transferred to the trust, then the annual exclusion may be available.[242] More typically, the terms of the trust restrict the rights of the beneficiary to currently receive the property transferred. To qualify for the annual exclusion, terms of such a trust include a *Crummey* demand right, named for a well-known court decision.[243]

A *Crummey* demand right gives the beneficiary of a trust a limited period of time to demand receipt of property transferred to the trust for which the donor desires to qualify for the annual exclusion. This time period is not set by law, but is typically set at 30 days because such a time period has been approved by the IRS. During the 30-day period, the beneficiary can demand that the trustee distribute the property subject to the demand right. If no such demand is made, the

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[239] Proposed legislation would limit the ability to use discounts to decrease the value of interests gifted between family members.
[240] Section 2035(c).
[241] Section 2503(b).
[242] Section 2503(c).
[243] *Crummey*, 397 F.2d 82 (9th Cir. 1968), which was accepted by the IRS in Revenue Ruling 73-405, 1973-2 CB 321. The IRS has issued many private rulings permitting a Crummey power to qualify a transfer for the annual exclusion provided that the withdrawal power lasts for at least 30 days and the power holder, or, in the case of a minor, his or her legal representative, receives notice of the existence of the power.

property remains in the trust, and the beneficiary has no further right to demand the property other than as provided by the terms of the trust.

Crummey demand rights are often used when the beneficiary of the trust is a minor child. In such a case, the minor child need not know that the right exists. Instead, notice of the demand right is given to the legal guardian of the minor, who is often the same person who is transferring the property to the trust. This may appear to create an illusory right, but the IRS approves of such an approach. The IRS does require, however, that an annual notice of the power be given. That is, the IRS will challenge the annual exclusion where the trustee gives a one-time notice with the power holder, or his or her representative, waiving the right to future notice.

The gift-splitting election is not available when a *Crummey* power is used because the election is not fixed until the Form 709 is filed, which will be after the lapse of the *Crummey* power.[244]

During the limited period that the beneficiary has the right to demand the property, he or she holds a general power of appointment over the property subject to the demand right. When the demand right lapses unexercised, the beneficiary has made a transfer that could create transfer tax consequences.[245]

These powers also have implications for the management of the business. Should the beneficiary be able to obtain property that is in fact an ownership interest in the business, the beneficiary could potentially act in ways that are not desired by the other owners. This is yet another reason for considering the use of non-voting interests during the gifting phase and withhold the transfer of the voting interests until the estate phase of the business transfer plan.

Charitable Remainder Trusts and Business Interests

Description

A charitable remainder trust refers to a *split-interest* transfer in which one person is provided with an income interest for life, or some designated time period, and the remainder interest, after the term of the income beneficiary's interest expires, is transferred to a qualified charitable organization.

A charitable remainder trust can offer both tax and nontax advantages. The income from the transferred property may continue to be used for the benefit of the donor, and a current income tax deduction may be obtained for the present value of the interest that will eventually pass to the charity.

To qualify the remainder interest for a current income tax deduction, the income interest must qualify as either an annuity interest or a unitrust interest.[246] An annuity interest promises to pay the income beneficiary an annuity (a fixed dollar amount) of at least 5 percent and not more than

[244] Letter Ruling 8022048.
[245] During the period that the beneficiary has the power to appoint property to himself, he will be taxed on any income attributable to trust property under §678(a)(1). It is also possible that the beneficiary will be taxed on income attributable to that portion of the trust even after the withdrawal power has lapsed. The lapse of the withdrawal power may be a release under §678(a)(2), which release shall treat that portion of the trust as a grantor trust with respect to the beneficiary.
[246] Section 664(d)(1).

50 percent of the value of trust assets at the time the trust is formed. The term of the annuity can be the life of the income beneficiary (or beneficiaries) or a specified number of years. If not for life, the term of years may not be more than 20 years.

A unitrust promises to pay the income beneficiary a fixed percentage interest, which must be at least 5 percent and not more than 50 percent of the value of trust assets.[247] A unitrust income interest, in contrast to an annuity interest, can go up or down as the value of trust assets changes each year. Also, a unitrust permits the donor to add assets after formation of the trust, an option not available to the annuity trust. If the assets are expected to substantially appreciate, the unitrust would result in the income beneficiary receiving more funds, and the charity less, relative to the constant-dollar payment received from an annuity trust. Of course, the higher the income interest, the less likely there will be appreciation in trust assets used to fund the income.

The greater is the annual income interest, the smaller is the charitable contribution deduction. The present value of the charity's remainder interest must be at least 10 percent of the value of the property transferred.

Advantages of Charitable Remainder Trusts

A transfer of appreciated stock to a charitable trust will allow the donor to claim a charitable contribution deduction based on the full value of the stock. The trust may sell the stock without paying any tax and the sale proceeds may then be used to fund an income payment to the donor and his or her spouse.

Charitable remainder trusts may be used as an alternative to, or as a supplement for, a qualified retirement plan. Such a trust would include a makeup provision, in which the trustee would be empowered to pay the holder of the income interest an extra amount to compensate for deficient payments in prior years.[248] The trust assets could be invested in high-growth assets early during the term with a later switch to high-income investments during retirement years.

If the trust is funded with appreciated stock in a closely held corporation, the donor's deduction may be based on the fair market value of the stock. The charitable remainder trust may then sell the stock without paying any tax.[249] The sale proceeds may then be invested for the benefit of the donor. Care should be taken, however, if the business interest consists of S corporation stock, as a charitable remainder trust is not an eligible shareholder and a transfer will terminate the S election.

Transfer of an interest in an LLC or a limited partnership may be a good choice to fund a CRT. However, if the CRT is liable for any portion of partnership debt, tax problems could result. The reason behind this recommendation is that an interest in an LLC or a partnership may result in a transfer of a portion of the entity's liabilities to the CRT under the rules of §752. It may also be possible for the grantor to remain personally liable for the debt and to continue to make payments. However, if the trust is required to make payments on behalf of the grantor, the trust may not be qualified even if the grantor retains personal liability for the debt because the trust's payment would create a grantor trust if trust income is applied to discharge a legal obligation of

[247] Section 664(d)(2).
[248] Section 664(d)(3).
[249] Section 664(c).

the grantor.[250] The IRS has approved a transfer of a partnership interest to a CRUT, where partnership properties were subject to nonrecourse financing but partners could be liable for capital calls because the grantor agreed to hold the CRUT harmless for any cash calls, expenses and losses associated with the partnership interest.[251] If a partnership interest is to be transferred, the partnership should not be engaged in a trade or business or the CRT risks loss of its tax exemption because of unrelated business taxable income.[252] It is best to transfer such an interest free of any debt and to have the interest sold shortly after the transfer so that the CRT is not engaged in a trade or business (partners are deemed to be in the trade or business of the partnership).

Succession Planning in a Closely Held Business

Overview

Closely held business interests are often not well diversified, so that a significant portion of a gross estate is composed of the value of a business. Thus, upon the death of the senior generation family member, a variety of tax problems arise, including

- Providing for the liquidity needs of the estate without an unwanted disposition of the business interests.
- Providing for a transfer of control from the senior generation to younger-generation family members selected by the decedent.
- Valuation of the business for estate tax purposes.

The liquidity needs of the estate and the orderly transfer within the family can be satisfied through buy-sell agreements among family members. If properly structured, the buy-sell agreements can also assist in establishing a value of the business for estate tax purposes.

In addition, while accountants are often hesitant to employ whole-life insurance due to what is perceived as a relatively low rate of return compared to other assets, the use of such insurance to fund buy-sell agreements warrants serious consideration. If the entity is the beneficiary of the policy, there is no regular income tax consequence when the policy proceeds are received.[253] However, if the entity is a C corporation, 75 percent of the proceeds will be included in the alternative minimum tax base through the adjusted current earnings adjustment. Thus, C corporations may be penalized where the buy-sell is structured as a redemption of the decedent's interest by the entity. However, many family businesses will qualify as "small corporations" under §55(e), which are exempt from the AMT.

[250] Letter Ruling 9015049.
[251] Letter Ruling 9533014.
[252] See Letter Ruling 9340043 for an example of IRS approval of transfer of a partnership interest where the partnership was not engaged in a trade or business.
[253] This assumes that the requirements of §101(j) are met for company owned life contracts entered after August 17, 2006. This discussion assumes that the covered individual would also be a director and that notice and consent requirements of this provision would be satisfied.

Buy-Sell Agreements

A buy-sell agreement can provide for the orderly transfer of ownership from one generation to another by restricting the rights of shareholders to transfer shares outside of the family. The buy-sell can also fix the value of the stock for estate tax purposes, making it easier to plan for liquidity needs by purchase of insurance on the lives of the business owners. In terms of fixing the value, it is important to understand that this does not mean a fixed dollar amount but rather a fixed model for determining the value of the company.

A CPA valuation expert will typically employ one of three methods (or a combination) to value the business. These methods are the use of comparable businesses, a discounted future cash flows, or asset appraisals. A CPA should consider all three methods in determining which method or combination should be used to fix the value of the interest.

To fix the value for estate tax purposes, the purchase price agreed to in the buy-sell must be reasonable, and not act as a device to shift value to surviving family members without imposition of a transfer tax. The IRS is aware of the incentives to set the price at a low value, to minimize transfer taxes. The low value would also result in a lower tax basis for the successor family members, but estate tax rates are higher than income tax rates, providing overall savings by minimizing the estate tax. Also, it may be planned that the family will never sell the shares, such that income tax basis is not a relevant decision point.

To be effective in setting a value for estate tax purposes, a buy-sell agreement must obligate the shareholder to sell the shares at the agreed-to price, both for transfers during the shareholder's lifetime and at death. The corporation, or the remaining shareholders, need not be obligated to purchase the stock. However, the shareholder may not have the ability to sell to the corporation or family members at any other price. For example, the buy-sell agreement may not provide that the corporation has the right of first refusal to match an offer from an outside party since the outside party offer would not be at the price agreed to in the buy-sell agreement.

When property is transferred between family members, the price set in a buy-sell agreement will be disregarded unless the agreement may be shown to meet the following requirements:[254]

- It is a bona fide business arrangement.
- It is not a device for the transfer of property to family members for less than full and adequate consideration.
- Its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction.

A formula buy-sell price, which is based on book value, may be respected for estate tax purposes if the requirements listed above may be satisfied. However, it is the author's recommendation that the services of a valuation expert employing an analysis of the three methods described previously be considered in setting the formula.[255]

[254] Section 2703.
[255] The Administration has proposed that consistency be required for valuation for both transfer and income tax purposes. It has also proposed that certain restrictions will be disregarded in arriving at valuation discounts.

Reducing the Estate Valuation of the Business Interests

Generally, a business interest is valued at fair market value, defined as the price that a willing buyer would pay a willing seller, neither being under a compulsion to buy or to sell and both parties being fully informed. In certain cases, a willing buyer would discount the value of a closely held business interest for a lack of marketability or a lack of control, among other considerations. As previously noted, this ability to employ discounts may be severely limited within family groups under proposed legislation.

Lack of Marketability

By definition, closely held businesses do not trade on an active exchange, and it is common for appraisers to discount the value of such businesses due to the time, effort, and uncertainty reflected in disposing of a privately held interest. A lack of marketability discount can apply to controlling interests in privately held businesses even if the controlling interest could compel a liquidation or sale of the company.

Discounts for lack of marketability depend on the facts of each particular situation but often range between 25 and 33 percent. A marketability discount can reduce the premium that would typically be assigned to a controlling interest in a closely held corporation.

Minority Discount and Control Premium

Related to the marketability discount is a minority discount (minority interests are more often not marketable). Courts are reluctant to allow both a minority discount and a lack of marketability discount. The value of a minority interest is less than a proportionate share of the total value of the company because minority shareholders have less voice in electing Board members, and their participation in day-to-day operations may be practically limited by the controlling shareholder.

In Revenue Ruling 93-12,[256] the IRS has agreed that in a closely held corporation with one class of stock, a minority discount will be allowed for stock owned by a single family member even if, in the aggregate, family members control the corporation. This position reflects the views of several courts, and the IRS has finally relented on fighting the issue. However, the IRS has recently argued for a *swing vote* premium when donees may be expected to have the ability to exercise control by joining together for voting decisions.[257]

The converse of a minority discount is a control premium, which recognizes that the shares that represent control of a privately held company are worth more per share than other shares.

Family S Corporation Issues

To avoid a shift of service income to other family members, the tax law requires that a reasonable amount of compensation be paid in family S corporations.[258] The IRS has broad authority to re-allocate items of income to properly reflect fair compensation for any services rendered. For this reason, it is essential to properly document the appropriateness of

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[256] 1993-1 CB 202.
[257] Letter Ruling 9436005, citing *Estate of Winkler*, TC Memo 1989-232.
[258] Section 1366(e).

compensation paid to a senior generation family member in an S corporation where substantial ownership interests are held by other family members.

When the Form 2553 is filed, the IRS letter acknowledging S status now contains a statement regarding the necessity of properly compensating owner-employees. Because of an increasing number of irresponsible tax "un"-professionals who are recommending that clients set up S corporations and pay themselves no salary in order to evade the self-employment tax, the Service has become very active in checking proper compensation of owner-employees. The IRS is also selecting cases for litigation in which the owner-employee provides virtually all of the services that generate income in the S corporation but which pay little or no salary. Since the absence of a salary is on its face not reasonable, the question of what would be a reasonable salary is never quantified. It is recommended that the minutes of the corporation's annual meeting include consideration of proper salary for owner-employees.

A gift of stock in the corporation *will* permit a shifting of income attributable to the capital of the business represented by that stock interest. Because S corporation income is allocated among the owners on a per-share, per-day basis, it is possible to shift income to family members in lower tax brackets if the stock that produces that income is transferred.[259] However, §1366(e) will prevent a shift of income that is created by the services of one or more family members. Thus, it is only income that is earned by capital that may be shifted to others.[260]

The limitation requiring that S corporations have only one class of stock for distribution purposes is significant because it requires that distributions, other than payments for salary or the use of property or capital (rents, royalties, or interest) will have to be made proportionately based upon stock ownership. This means that the donor will be unable to transfer interests to other family members yet be the only shareholder who receives distributions, which is a common characteristic of problematic family limited partnership structures. In the case of the family S corporation, having disproportionate distributions would terminate the S election because of the distributions creating a de facto second class of stock.

It should be noted again that simply having different voting rights is not problematic. It is possible for the S corporation to have both voting and non-voting shares as long as the shares have equivalent rights to distributions. Therefore, it is possible for the donor to retain the voting interests in the corporation until death while transferring only the non-voting interests during lifetime. The key factor in avoiding a second class of stock problem is that the distributions paid out will also shift to the donee as he or she holds more stock and the donor holds less. This issue will make it more important for the donor to provide services or the use of property that can be paid in a form other than distributions based on stock ownership as more and more of the stock is shifted to the donee.

In addition to the proportionate distribution rule, there is one other potentially large disadvantage of the family S corporation in relation to the family partnership. This disadvantage is the inability of an S corporation to employ the §754 election rules to step-up the inside basis of the heir's share of the entity's assets when the outside basis steps up as a result of the estate event. The

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[259] Section 1377(a).
[260] Legislative proposals have been entertained that would levy employment taxes on the ordinary income share of service shareholder-employees of certain S corporations and the shares of certain family members holding stock in the S corporation.

§754 election is part of Subchapter K and is strictly a partnership provision. This is discussed in the next section, related to partnerships and is a distinct advantage of family partnerships (or LLC's taxed as partnerships) over family S corporations in some cases.

One factor common to both the family S corporation and the family limited partnership (or now LLC as well) is the use of discounts for gift and estate tax valuation because of restrictions on the ability to sell the ownership interests and the inability to vote or operate in management. These discounts are often subject to a great deal of controversy between the Service and taxpayers. In fact the actual discount allowed is often the result of a court's evaluation of dueling experts in valuation provided by the taxpayer and the Service. It is recommended that a valuation specialist who has experience in estate and gift tax implications as well as general business valuation be used to set the value of the interests for estate and gift tax purposes.

A potential limitation on the use of an S corporation is that it may have only 100 shareholders. However, as many as six generations of family members may be treated as one shareholder, and a husband and a wife are always treated as one shareholder. Also, S corporations are limited as to the types of trusts that may hold their stock, should the stock be moved inside a trust. A QSST is a type of qualifying trust which may have only one income beneficiary, and corpus distributions during the life of that income beneficiary may be made only to the beneficiary.

An electing small business trust (ESBT) may also own S corporation stock. An ESBT may have multiple beneficiaries (each of whom is counted against the 100 shareholder limit) and may sprinkle income and distributions among beneficiaries, including corpus distributions to parties other than current income beneficiaries. However, all trust income is taxed at the maximum individual tax rates whether such income is distributed or not.[261] Thus, LLCs and FLPs still offer more flexibility in structuring ownership interests for family members because full pass-through treatment is available, and a trust may be a partner or a member while preserving the modified pass through rules of Subchapter J (the rules are modified in the sense that either the fiduciary or the beneficiary, but not both, will be taxed, and the beneficiary's tax rate is likely to be lower than the trust's rate).

Family Partnership (or LLC) Issues

Family limited partnerships (FLPs), so-called because the partners are members of the same family, have long been used for business and tax purposes. Because limited liability companies (LLCs) are a relatively new invention of state law, they have gotten less attention from tax advisors seeking valuation discounts for their client's assets. An increased understanding of the LLC may enhance the use of the LLC as an estate planning tool. However, whether the CPA recommends use of an FLP or an LLC, it is essential to document a business purpose for creation of the entity.

A significant issue to address when suggesting use of an FLP or LLC is which assets should be placed into the entity. Regulations issued in January 1995 suggested that the IRS may challenge the use of FLPs for purely investment assets, such as marketable securities, life insurance policies, or a vacation home.[262] The examples that supported such a challenge were removed

[261] Section 641(c).
[262] Reg. §1.701-2.

from the regulations, but IRS officials have made it clear that they will challenge inappropriate use of the partnership form including attempts at valuation discounts. A business purpose for the transfer of assets to the FLP or LLC is essential to using these entities successfully for transfer tax savings.

The IRS has attacked FLPs when there is no apparent business purpose for the entity (see, for example, FSA 2001434004). The Tax Court has refused to ignore the separate existence of a validly formed state law partnership, even when the taxpayer has failed to follow normal formalities associated with the entity.[263] Nonetheless, it is suggested to document a business reason for creation of the entity.

The existence of a business purpose helped the taxpayer defeat an IRS attempt to include FLP assets in the decedent's estate under Section 2036.[264] The IRS has successfully used Section 2036 in other FLP cases, particularly when the taxpayer did not retain sufficient assets outside the FLP to meet basic living needs.[265]

The CPA, generally with the assistance of an attorney, should carefully document the business purpose for a transfer of assets to an FLP or LLC. Proper management of family assets, including liability protection, centralized management and retention of assets within the family, and involvement of children in a family enterprise may be business reasons for the transfer. Protection from creditors, who may be limited to obtaining a charging order against a limited partnership interest, may also be an important reason for the transfer. Consolidation of control over assets and avoidance of ancillary probate for out-of-state real property holdings may also be a reason for using an FLP or LLC. These reasons may apply to marketable securities as well as to business assets. However, it is important to avoid using an FLP or LLC solely to obtain a valuation discount when no business reason for the transfer of assets can be justified.

Family Partnerships and §704(e)

Section 704(e) is designed to prevent the use of a partnership to shift income from services to a donee partner and to ensure that no more than a proportionate share of income from capital may be shifted to a donee.

Section 704(e) provides that a donee partner will be recognized as a partner for tax purposes provided that capital is a material income-producing factor in the partnership. That is, the IRS need not agree that a donee partner in a service partnership will be respected as a partner, but a donee in a capital partnership will be so recognized. This distinction is consistent with a general principle of tax law, that income must be taxed to the person who earned it. Income from capital may be shifted to another, as may occur by transfer of an interest in a partnership in which capital is a material income-producing factor.

To prevent use of a partnership to shift income from services, §704(e) requires that a donor of a partnership interest receive reasonable compensation for services rendered.[266] If the donor's

[263] *Strangi*, 115 TC 478 (2000), and *Knight*, 115 TC 506 (2000).
[264] *Stone*, TC Memo 2003-39.
[265] See, as examples, *Thompson*, TC Memo 2002-246, *Strangi*, TC Memo 2003-145, *Abraham*, TC Memo 2004-39, and *Turner*, 382 F.3d 367 (3rd Cir., 2004).
[266] As discussed in Chapter 3, this will technically be in the form of a guaranteed payment and subject to self-employment tax.

compensation for services is determined without regard to income of the partnership, the entity will be entitled to a deduction under §707(c) and the service partner will include the income as a separately stated item. Section 704(e) also prohibits an allocation of income to the donee partner that is disproportionately large in relation to the donee's interest.

Section 754 Basis Adjustments

A significant advantage of an FLP or an LLC is the ability to use a §754 election to step up the basis of assets held by the decedent's interest in a partnership. Section 1014 allows for an adjustment to the basis of assets received from a decedent. If the asset received from the decedent is an interest in a closely held business, the basis of the interest will itself be adjusted. That is, the stock of a corporation or the interest of an LLC or a partnership will be adjusted. However, subchapter S does not allow for any adjustment to the basis of the assets of the corporation.

In terms of partnership language, the estate event (when an estate tax is in place) allows for a step-up in the outside basis of the partnership interest (or stock in a corporation), which occurs regardless of the entity type. However, only the case of an entity which is taxed as a partnership and which has a §754 election in effect obtains a parallel increase in the inside basis of its assets with respect to the heir's share of those assets. Thus, a later sale of assets will result in an allocation of income to the shareholder who inherited the stock even if the appreciation attributable to such assets occurred before the decedent's death. In contrast, if a partnership or LLC has a §754 election in effect, the assets represented by the inherited interest will be adjusted to the basis of the interest.

Corporate Redemptions to Pay Death Taxes

A §303 redemption may qualify all or a portion of a redemption for exchange treatment. The stock redeemed must have been included in the decedent's estate and exchange treatment is available only to the extent that proceeds of the redemption do not exceed the sum of any estate, inheritance, legacy, and succession taxes imposed, and any funeral and administrative expenses deductible under §§2016 or 2053.

Section 303(b)(2) requires that the value of the stock included in the decedent's gross estate exceed 35 percent of the adjusted gross estate (gross estate minus §§2053 and 2054 expenses).

There are several planning opportunities and pitfalls associated with §303 redemptions, including the following:

- Because the basis of the stock has been adjusted to fair market value as of the date of death,[267] a redemption that qualifies as an exchange will result in no gain or loss, except to the extent that the stock appreciated or depreciated after the decedent's death. Thus, the redemption is a way to withdraw profits tax-free.
- The interest of the shareholder whose stock is redeemed must be affected by the death taxes and funeral and administrative expenses incurred. This rule may require predeath planning for a §303 redemption. For example, assume that a surviving spouse acquires all

[267] Section 1014.

of the stock, but that all taxes and administrative expenses are paid from the share that passes to the children. Because the spouse's interest in the estate is not reduced by the taxes and expenses, a §303 redemption is not possible.

- Predeath planning may be advisable to ensure that the stock retained in the decedent's estate satisfies the 35 percent test noted above. Thus, if a program of lifetime giving is contemplated, it may be best to give some assets other than stock in the closely held corporation if a §303 redemption is later contemplated.
- The §303 provisions apply to substituted basis stock.[268] Thus, a recapitalization of the corporation may be conducted after the decedent's death to create voting and nonvoting stock. The recapitalization should be tax-free under §368(a)(1)(E), and the new stock will have a substituted basis. The nonvoting shares may then be redeemed in the §303 transaction. This allows the redeemed shareholder to preserve his or her voting rights in the corporation.

Why a Recapitalization?

Assume that a family owns 70 percent of a closely held corporation, while the other 30 percent are held by outsiders. A §303 redemption of the family's stock would reduce its voting control, perhaps below 50 percent. The family could approve a recapitalization that creates voting and non-voting shares for all shareholders. The family could then redeem the nonvoting stock, allowing it to continue to control all corporate affairs, including those that require a super majority (2 to 3) vote.

A §303 redemption is available in both C and S corporations. It is not available to interests held in a partnership or LLC form.

Case Study 6-1: Charitable Remainder Trust

Facts

Kelly Moody owns an interest in a closely held business, which interest has a fair market value of $3 million and a tax basis of $300,000. Kelly has no interest in participating in the management of the business, but she would like to receive a regular income payment from her interest. Because she receives minimal income distributions from the business interest, Kelly would like to sell the interest and invest in some alternative that yields a higher income. The managing owners of the entity would be willing to redeem Kelly's interest, but Kelly is concerned about the tax burden on a $2.7 million capital gain.

The interest may be held in an LLC, a limited partnership (in which Kelly is a limited partner), a C corporation, or an S corporation. Kelly has heard that a charitable remainder trust may be an effective way to sell her interest to the entity with no income tax consequences, and she needs to know more about the benefits of such a trust. Compare the ability to shift income from the appreciated interest to a charitable trust assuming that the interest is held in the four possible types of entities mentioned previously.

[268] Section 303(c).

Discussion

Because Kelly's principal desire is to realize a reasonable income from her investment and because the other owners are willing to redeem her interest, Kelly should consider a transfer of the interest to a charitable remainder trust (CRT) which will pay her an income return based upon the value of the assets transferred. The CRT would sell the interest to the entity, and the trust, as an exempt taxpayer, would owe no tax on the resulting gain. The trustee of the CRT could then invest the $3 million proceeds to produce a high income return for Kelly. When the trust term is over, which may be at Kelly's death, any remaining assets will pass to a designated charity.

A charitable remainder trust is an irrevocable split-interest trust in which one or more noncharitable beneficiaries receive a lead income interest, payable at least annually, for a life or lives, or for a term of years not to exceed 20, and a qualified charitable organization receives the remainder.[269] If the trust qualifies as a charitable remainder annuity (CRAT) or unitrust (CRUT), a charitable contribution deduction equal to the present value of the remainder interest is allowed each time that funds are transferred to the trust.[270]

A CRAT requires the payment of a fixed dollar amount, that is, an annuity, to the holder(s) of the income interest, and that annuity must be at least 5 percent and not more than 50 percent of the initial value of the trust assets.[271] The grantor of a CRAT may not make annual additions of property to the trust. In contrast, a CRUT will pay the income interest holder(s) a fixed percentage of the value of trust assets, and the dollar payout will fluctuate with changes in the value of trust assets. The income interest must be at least 5 percent of trust assets as of the valuation date, and annual additions may be made to the trust.[272]

For transfers after July 28, 1997, the present value of the charity's remainder interest must equal or exceed 10 percent of the value of assets transferred. This new requirement means that Kelly's retained income interest may need to be a smaller percentage than she may want, or that the term of the income interest may need to be limited. Many taxpayers have funded CRTs to satisfy personal financial objectives and a desire to benefit a charitable organization may not have been a principal purpose for establishing and funding the trust. The requirement that the charity's interest be at least 10 percent of the value of assets transferred may be an impediment to such taxpayers.

If, when the trust is created, the grantor is not certain which charity should receive the remainder interest, the trust terms may permit a change in the designated charitable beneficiary. Reg. §1.664-3(a)(6)(iv) permits such a change where the named remainder beneficiary no longer qualifies as a §170(c) organization when the interest is to vest. In Revenue Rulings 76-7 and 76-8, the IRS approved the right to change charitable beneficiaries for reasons other than the named beneficiary no longer qualifying,[273] ruling that the prohibition on altering or amending trust

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[269] Reg. §1.664-1(a)(1)(i).
[270] Section 170(f)(2)(A).
[271] Reg. §1.664-2(a).
[272] Reg. §1.664-3(a).
[273] Revenue Ruling 76-7, 1976-1 CB 179, deals with a testamentary charitable remainder trust in which the income beneficiary has a special power of appointment to designate a charity. Revenue Ruling 76-8, 1976-1 CB 179, deals

terms to the detriment of the charitable beneficiary does not preclude a substitution of one qualifying organization for another. However, the income tax deduction for contributions to the trust will be limited to 20 percent of the grantor's adjusted gross income if the terms permit an amendment that would transfer assets to a 20 percent charity.[274] If the right to change charitable beneficiaries is to be given to the grantor or some other party, and the 20 percent limitation could limit the current deductibility of the gift,[275] the terms could specify that the designated charity must be a 50 percent charity.

A CRT can be funded with money or property. A significant advantage of a charitable remainder trust is the ability to shift unrealized appreciation from long-term capital gain assets to the tax-exempt trust.[276] A contribution of appreciated long-term capital gain assets allows the donor to deduct the fair market value of the property.[277] If contributed property does not yield a reasonable income, the trustee must be granted the flexibility to invest to produce a reasonable return. The trust may sell contributed assets without paying tax, and the donor's ability to escape tax on the unrealized gain is similar to a contribution of pretax dollars. The tax savings generated by transferring unrealized gain to the trust can make the CRT superior to alternative investments that may be suitable for private retirement funding.

Stock in a closely held corporation is a good candidate to fund a CRT, although the charitable trust is not an eligible S corporation shareholder. Thus, transfer of S corporation stock will terminate the election, although inadvertent termination relief may be available if the transfer occurred before the tax advisor was consulted.[278]

If contributed property is encumbered, several problems may arise if the property is transferred with the debt. First, the trust may be taxed on unrelated business taxable income under the debt-financed income provisions of §514.[279] If any portion of trust income is unrelated business taxable income, all of the income becomes subject to tax.[280] Second, the trust's payment of the grantor's liability may be an act of self-dealing as defined in §4941(d), creating the potential for a penalty tax. Finally, the transfer will be a part-gift, part-sale.[281]

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with an *inter vivos* charitable remainder trust in which the grantor retained the power to change the charitable beneficiary.

[274] Revenue Ruling 79-368, 1979-2 CB 109.

[275] The charitable deduction will generally not be substantial enough to trigger a deduction limitation.

[276] However, see *Ferguson*,108 TC 244 (1997), aff'd., 174 F. 3d 1004 (9th Cir., 1999), for an analysis of when a sale may be taxed to the donor under anticipatory assignment of income principles.

[277] Although the deduction may equal the fair market value, the 50 percent of AGI limitation is reduced to 30 percent under §170(b)(1)(C)(i).

[278] See Revenue Ruling 92-48, 1992-1 CB 301, and Letter Ruling 8922014.

[279] The debt-financed provisions are generally not a concern because the CRUT's obligation to pay the unitrust interest does not constitute acquisition debt. See Reg. §1.514(c)-(1(g).

[280] Reg. §1.664-1(c).

[281] Reg. §1.1011-2.

Case Study 6-2: Basis Adjustments after Death[282]

Facts

Frank Moline owns a 30 percent interest in a business entity. The assets represented by Frank's 30 percent interest are as follows:

	Fair Market Value	Inside Tax Basis
Cash	$40,000	$40,000
Inventory	80,000	35,000
Equipment	150,000	90,000
Real Property	300,000	170,000
Totals	$570,000	$335,000

Frank's will transfers his 30 percent interest to his daughter Sharyn. Frank's basis in his interest in the business entity is $270,000. There are no items of income in respect of a decedent attributable to Frank's interest and there is no unrecorded goodwill in the business.

The entity may be assumed to be an LLC or an S corporation. The discussion compares the tax treatment of Sharyn if she inherits stock in an S corporation or an interest in an LLC.

Discussion

If the business is in the S corporation form, and if Sharyn inherits Frank's 30 percent interest, her basis in the stock will be $570,000 as a result of the §1014 basis adjustment for property received from a decedent. A sale of the stock for its fair market value would result in no gain or loss. However, the corporation's basis in its assets will not change as a result of Frank's death. Sharyn's share of the *inside* basis of the assets of the corporation will remain at $335,000.

If Sharyn inherits S corporation stock and if the corporation subsequently sells all of its assets for the fair market value shown above, Sharyn will receive a Schedule K-1 reflecting her share of the corporate gain, which share will be $235,000. The character of the gain will flow through from the corporation, and may be $105,000 of ordinary income and $130,000 of §1231 gain if the equipment is subject to §1245 recapture and the real property is not subject to either §1245 (pre-1987 nonresidential property) or §1250 (pre-1987 residential property) recapture.

The flow-through gain will increase the basis of Sharyn's S corporation stock from $570,000 to $805,000. If she then receives a liquidating distribution of $570,000, her share of the value of corporate assets, she will report a $235,000 capital loss under §331.

The result of the above transactions is that Sharyn recognizes $235,000 of gain as corporate assets are sold (or, under §§311(b) or 336, are deemed sold as a result of a distribution), of which $105,000 may be ordinary income. In exchange, Sharyn recognizes a $235,000 capital loss when her stock is canceled in liquidation of the corporation. Thus, without any change in the value of corporate assets, Sharyn reports net losses to offset her gains, but the timing and the character of income and loss will be detrimental to her.

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[282] For purposes of the cases in this chapter, assume the estate tax is in place.

If the entity is an LLC, there are two possible results. The first is exactly as is shown above for an S corporation and will occur if the LLC has no §754 election in effect.[283]

If the LLC has a §754 election in effect before Frank dies, or if an election is made with the LLC return for the year that the interest is transferred as a result of Frank's death, Sharyn will be entitled to adjust the inside basis of the assets represented by her inherited interest.[284] She would then be entitled to an overall adjustment of $235,000, which will be allocated among assets as provided by Regulations §§1.755-1(a) and -1(b).

If the entity is an LLC and if the §754 election is in effect, a sale of assets by the LLC will result in an allocation of gain to Sharyn, which gain will then be offset by her §743(b) adjustment. The net effect will permit Sharyn to avoid the timing and character of income problems associated with the S corporation form.

Case Study 6-3: Using Family Limited Partnerships and LLCs for Valuation Discounts

Facts

Father has a variety of appreciated investments and business interests. He has heard that a family limited partnership (FLP) would be an excellent way to transfer assets to his four children with minimal transfer tax consequences. Father needs additional information with respect to the advantages of using an FLP (or an LLC) to transfer wealth to his children.

Discussion

When assets are transferred to an FLP, it is often stated that a valuation discount may be obtained. For example, if Father transfers $1 million of real property to an FLP and gives a 30 percent interest to one or more of his children, the interest will be valued at less than 30 percent of $1 million, perhaps 35 to 50 percent less. Technically, there is no actual "discount" in the value of the child's interest—it is worth fair market value. However, the inability of the child, as a limited partner, to control the property, to sell his partnership interest, or to compel a liquidation of the partnership with a distribution of the child's share of the property, will mean that a willing buyer would pay less than $300,000 for the interest. The parent may then continue to control the property, shift any appreciation attributable to the child's interest out of the parent's estate, and also obtain a gift tax valuation for the child's interest that is less than the net asset value represented by that interest.

In December of 1996 the IRS issued final regulations under §7701 that provide a default rule that an unincorporated entity with at least two members will be a partnership. The regulations are effective for entities formed after 1996. The enactment of these regulations may provide an impetus for states to permit LLCs to provide for less flexibility to dissolve the entity upon a dissolution event, thereby creating the corporate characteristic of continuity of life. Such a

[283] However, possible differences between an LLC and an S corporation could occur if the LLC agreement provisions provided for a special allocation of the types of gains involved in the transaction. For purposes of this discussion, assume that no special allocation provisions exist.
[284] Section 743(b).

change may increase the discount available for an LLC interest because the member's right to dissolve the entity and receive assets is reduced.

Father should be encouraged to consider using an LLC or an FLP in which the children have no management authority over the transferred assets. However, he should select assets so that a business purpose may be established for the transfer to the entity.

Parents who retain the right to vote shares of stock transferred to children, such as by serving as trustee of a trust that holds the shares, will have such shares included in their estate under §2036(b). A transfer of a limited partnership interest will allow the parent to continue to control the ownership of the business without any §2036(b) concerns. An LLC could be used for the same purpose because §2036(b) applies only to retention of control in a corporation.

LLCs and FLPs may also permit more flexible planning for the structure of the children's interests.

FLPs may make it easier to support a valuation discount when interests in a business are transferred to family members. As mentioned earlier in this chapter, discounts may be available for a minority interest and for a lack of marketability. Because limited partners' rights are limited by the Revised Uniform Limited Partnership Act, it is often easier to support a discount for the inability of the owner to participate in management, including the right to liquidate the entity and to receive the net asset value represented by the interest.

In addition, §754 allows a basis adjustment to the assets of a partnership or an LLC when an interest is received from a decedent. There is no similar adjustment to the assets of an S corporation.

Case Study 6-4: Corporate Stock Redemption from an Estate

Facts

Kelco Inc. is a family-owned business that adopted a buy-sell agreement funded by insurance on the lives of shareholders. The buy-sell was structured as a redemption. A total of 1500 shares of stock are outstanding, all owned by Harriet Kelty and her two children. Kelco's earnings and profits balance is approximately $6 million.

Harriet Kelty owns 1000 shares of Kelco stock, valued at $3,000,000. The remainder of her gross estate is valued at $6,000,000. Funeral and administrative costs are projected to be approximately $500,000 if Mrs. Kelty were to pass away now. The estate would be expected to pay $2,000,000 in federal and state death taxes.

Mrs. Kelty wants to know how §303 would benefit her estate assuming that the family business interest continues to be held in the C corporation form. The beneficiaries of the estate are Harriet's two children.

Discussion

The estate will have a basis of $3,000,000 in the shares that are proposed to be redeemed.[285] Because of the high level of earnings and profits, the redemption will be either (1) tax-free if it qualifies as an exchange or (2) a $3,000,000 dividend if it does not qualify for exchange treatment.

Section 302 will classify the redemption as a distribution subject to §301 and thus taxable as a dividend. This is so because the estate will be deemed to own all of the shares of the corporation both before and after the redemption (the beneficiaries' ownership is attributed to the estate). The §302(c)(2) attribution waiver for complete termination redemptions generally applies only to attribution from family members. A redemption of stock held by an entity may not qualify for a waiver unless both the entity and each related party terminate their ownership interests, agree to the waiver provisions, and are jointly and severally liable for any tax.

Section 303 will apply to the extent that redemption proceeds are used to pay death taxes and funeral and administrative expenses. Harriet's estate will qualify for §303 because the value of Kelco stock exceeds 35 percent of the value of the gross estate reduced by funeral and administrative expenses (35 percent of $8.5 million is $2,975,000; the stock is valued at $3,000,000).

Section 303 permits a redemption to qualify for exchange treatment to the extent of the death taxes and funeral and administrative expenses. Thus, $2,500,000 qualifies for exchange treatment and $500,000 is a dividend.

[285] Section 1014.