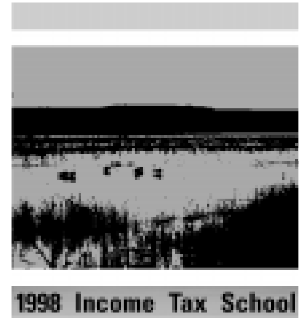
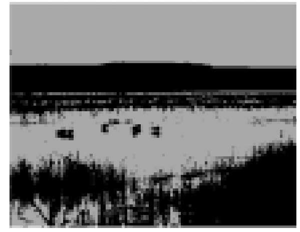


CHOICE OF ENTITY CONSIDERATIONS

The objective is not to try to find one form of business entity that is best for all clients, or even for all clients in a similar industry or ownership pattern. Instead, the purpose is to equip tax professionals to choose the most appropriate form of business organization tax treatment of the transactions that are most important to a given client at a given place and time.



1998 Income Tax School

CHOICE OF ENTITY CONSIDERATIONS

In prior editions of the *Farm Income Tax School Book* there have been Chapters discussing C corporations, S corporations, partnerships and limited liability companies. The 1998 edition seeks to compare these various entities by analyzing various transactions and comparing the tax treatment for each type of entity.

> The objective is not to try to find one form of business entity that is best for all clients, or even for all clients in a similar industry or ownership pattern. Instead, the purpose is to equip tax professionals to choose the most appropriate form of business organization tax treatment of the transactions that are most important to a given client at a given place and time.

ENTITY CLASSIFICATION

SITUATION 1: *Three individuals form a limited liability company in Ohio. Assuming that the three are all U.S. citizens or residents, and there is only one class of owner, what is the default classification of this company for federal tax purposes?*

- **Discussion:** The Internal Revenue Code recognizes two basic entities for tax purposes – the corporation and the partnership. A limited liability company is not specifically recognized in the law. Therefore it must fall into one of the two business categories, or it must be classified as a complete nonentity for tax purposes. Pursuant to the "check the box" regulation issued in late 1996, an unincorporated domestic organization with two or more owners **receives a default classification as a partnership. (Regulations §301.7701-3(b)(1)(i).)**

- **Historical Note:** Before 1997, the classification of a limited liability company for tax purposes was somewhat uncertain. In general the Regulations focused on four characteristics of a corporation, that were generally not found in partnerships. **Regulations §301.7701-3,** prior to amendment on December 18, 1996.

  1. Continuity of life;
  2. Transferability of interests;
  3. Centralized management; and,
  4. Limited liability of owners.

If an unincorporated organization had three or four of these characteristics it was subject to classification as a corporation. By contrast, an organization with only one or two of these characteristics would be classified as a partnership, provided it had two or more owners. During this era, the IRS issued several rulings determining the tax status of Limited Liability Companies.

SITUATION 1 (continued): *Could the company be treated as a C corporation? What would the parties need to do in order for this to happen?*

■ **Discussion:** Any unincorporated organization may elect out of its default status. Thus, a domestic organization may elect to be classified as a corporation for tax purposes, and a foreign organization may go either way. The election must be filed within 75 days following the date on which the status is to be effective. **(Regulations §301.7701-3(c)(1)(i)).** The organization must file Form 8832, reproduced on page 309 of the *1997 Farm Income Tax School Book*. An entity may not file an election to change its status until 60 months have expired from the last election. **(Regulations §301.7701-3(c)(1)(ii).)**

Observation: Many limited liability companies are established in order to give the owners protection from business debts (in the same manner as shareholders in a corporation), but to attain partnership tax status for the entity. Thus, there should be few situations in which a domestic organization elects out of its default status. From 1954 through 1969, the tax law permitted an unincorporated organization to be treated as a corporation. (**§1361,** prior to its repeal by the Tax Reform Act of 1969. Note that this is not the same section as **§1361** under current law). The justification for repeal of prior **§1361** was that it was deadwood. It is difficult to see why this option should become popular now, since it was so little used before.

SITUATION 1 (continued): *Could the company be treated as an S corporation? What would the parties need to do in order for this to happen?*

■ **Discussion:** This association could be treated as an S corporation if it met all the requirements thereof, and made a proper election. There would be two necessary steps:

1. The organization **must first** elect to be classified as a corporation, rather than as a partnership, under Regulations **§301.7701-3(c),** above. It must observe the 75-day grace period limitation if it intended this election be retroactive.
2. The organization **must also file Form 2553** to be treated as an S corporation. This election would only be valid if the organization were treated as a corporation for federal income tax purposes. This election must be filed within 2 months and 15 days (not necessarily exactly 75 days) after the start of the taxable year for which it is to be effective.

SITUATION 2: *Caroline, a U.S. citizen, forms a single-member limited liability company in Texas. There are no other owners. What is the default classification of this company for federal tax purposes?*

■ **Discussion:** This organization would be nonexistent as a separate entity for federal income tax purposes. A domestic organization **with only one member is disregarded** as a separate organization for tax purposes. **(Regulations §301.7701-3(b)(1)(ii)).** Accordingly, Caroline would treat the income and loss items of the company in the same manner as a proprietorship. Business income and deductions would be reported on Schedule C of her Form 1040; other items, such as gains and losses or interest or dividend income of the company, would be reported on her tax return as if she had received it directly.

■ **Historical Note:** Before 1997, the classification of a single-member limited liability company was problematic. Although the tax law has long recognized single-owner corporations, it could not comprehend the single-member partnership. Therefore, the IRS would not rule on the classification of a single-member limited liability company.

SITUATION 2 (continued) *Could the company be treated as a C corporation? What would Caroline need to do in order for this to happen?*

■ **Discussion:** Caroline could elect to treat this company as a C corporation by following the same procedures described under **Situation 1,** above.

SITUATION 2 (continued) *Could the company be treated as an S corporation? What would Caroline need to do in order for this to happen?*

■ **Discussion:** Caroline could elect to treat this company as an S corporation by following the same procedures described under **Situation 1,** above. Again, she would need to first be sure that the company was treated as a corporation for federal income tax purposes. Then she would need to file a proper S election.

CONTRIBUTIONS OF PROPERTY

SITUATION 3: *McGwire, long-time horse racing enthusiast, and Sosa, retired jockey and now well-known trainer, decided to join forces to develop the next Whirlaway. McGwire contributed a horse worth $100,000 (basis $20,000) to Newco for a 50% interest. Sosa agreed to train the horse and provide related services for the business in exchange for his 50% interest.*

- **What are the tax consequences to McGwire, Sosa, and Newco if the entity is a corporation, and both individuals receive equal amounts of common stock?**

■ **Discussion:** The receipt of stock to both McGwire and Sosa would be a taxable event, due to two causes. First, Sosa would be required to report the value of stock he received as compensation for services. [**§83.**] If there were any period for which Sosa was required to remain in the employment of Newco before he would be vested in the stock, he would not be required to report the gross income until he was completely vested. [**§83(a).**] In that situation he could make an election to report the fair market value of the stock as gross income immediately. [**§83(b).**]

McGwire would not be able to defer recognition of gain on his contribution of property to the corporation, even though he contributed property and received common stock. Although this looks like it might qualify under **§351,** McGwire does not own sufficient stock after the transaction to constitute the 80% minimum required for control [**§368(c)**]. Although Sosa was a party to the same transaction, he received his stock in exchange for services, which are not property within the meaning of **§351.**

McGwire acts as if he had sold the horse to the corporation at its fair market value. The sale would be

Fair market value of horse	$ 100,000
Adjusted basis of horse	(20,000)
Gain to McGwire	80,000

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Newco would not report any gain or loss due to the exchange of its stock for the horse. **[§1032.]** Newco would claim a compensation deduction equal to the gross income reported by Sosa, at the same time Sosa reported the compensation. [**§83(h).**]

All parties concerned would receive a fresh start basis, equal to the fair market value of the property received. Thus McGwire would take basis of $100,000 in his stock, as would Sosa. The corporation would claim a basis of $100,000 in the horse contributed by McGwire.

Note: The parties have agreed that the fair market value of the business is $200,000, if they are willing to grant McGwire a 50% interest in exchange for property valued at $100,000. However, the payment to Sosa would be a diminution of the corporation's assets, and would reduce the value back down to $100,000–the value of the horse.

- **Could Newco possibly be an S corporation? What are the tax consequences to McGwire, Sosa, and Newco if the entity is an S corporation?**

■ **Discussion:** If Sosa and McGwire are U.S. citizens or residents, it appears that Newco could be an S corporation, since there is only one class of stock. The corporation would need to file a timely election under subchapter S within 2 months and 15 days of the beginning of the taxable year in order for the S election to take effect immediately. **[§1362(b)(1)(B).]**

If the parties failed to make a timely election for the first year, the election could take place for the second and subsequent taxable years of the corporation. [**§1362(b)(1)(A).]** However, most corporations are better served by making an S election for their first year of existence. In this example, there would be no way to pass Sosa's compensation deduction to the shareholders if the S election were not in effect immediately. Thus the parties need to observe some cautions.

A corporation's first taxable year begins on the day that the corporation issues shares, commences business, or receives property, whichever happens first. **[Regulations §1.1362-6(a)(2)(ii)(C).]** If the parties intended to make a timely election but failed to do so, they could most likely receive some relief. The IRS is authorized to allow late elections as if they were timely filed, if there is reasonable cause for the delay. **[§1362(b)(5).]** If the request is less than six months late (less than 9 months and 15 days after the beginning of the taxable year) the Service center may approve the request with very little formality and no ruling fee. **[Rev. Proc. 97-40, 1997-33 IRB 50.]**

The same rules regarding contributions of property and services apply to all corporations, whether or not they have an S election in effect. In this example, the parties would recognize the same income and gain as above, since McGwire did not control the corporation. **However,** the compensation to Sosa would be deductible to the corporation and would reduce the taxable income (or increase the loss) that passes through to the shareholders for the first year. Therefore, the tax burden would not be as great if the corporation were an S corporation for its first year.

- **What are the tax consequences to P, S, and Newco if the entity is an LLC?**

■ **Discussion:** Assuming that the LLC is classified as a partnership for tax purposes, all of the partnership tax rules would apply to the LLC and its members. The results are less costly, although more complicated, than if Newco is a corporation. Under **§721,** a person who transfers property in exchange for an interest in a partnership does not generally recognize gain. [**§721(a).**] There are exceptions for certain investment companies, and for transfers to some foreign partnerships. Therefore, McGwire would not recognize gain on his transfer of the horse to Newco. Unlike a transfer to a corporation, there is no requirement that the transferor of property to a partnership have any particular percentage of the equity after the transfer.

Sosa would be required to recognize compensation income in the same manner as above. However, at this point the rules become quite complicated. Under general principles of tax law, Sosa is treated as having received a 50% interest in the horse in exchange for services performed. [See Regulations §1.86-6.] Thus to complete the hypothetical steps in this transaction the parties must treat McGwire as if he had sold a 50% interest in the horse to Sosa at its fair market value. The sale would be

Fair market value of 50% of horse	$50,000
Adjusted basis 50% of horse	(10,000)
Gain to McGwire	$ 40,000

McGwire then receives a $50,000 deduction for Sosa's compensation.

Sosa would be treated as having contributed $50,000 (50% of the interest in the horse he had purchased in exchange for his services) to the partnership. He would thus take a basis of $50,000 in his interest in the partnership.

SITUATION 4: *Jay and Karen have owned and operated Video for several years. This year they have decided that the business should expand by admitting some new blood, Norm, who owns an outlet at the local mall that would be perfect for a new location for Video's expansion. Norm will contribute the lot worth $100,000 (basis $20,000) to the company in exchange for a 20% interest.*

- **What are the tax consequences to Norm and Video if the entity is a C corporation?**

■ **Discussion:** Although Norm is transferring property to a corporation in exchange for stock, he does not meet the minimum 80% control requirement of **§351.** There is no other nonrecognition rule that applies to a transfer of property to a corporation, except for a tax-free reorganization. Therefore, this exchange is a **completely taxable sale** by Norm to Video.

- **What are the tax consequences to Norm and Video if the entity is an S corporation?**

■ **Discussion:** As is discussed above, an S election has absolutely no effect on the operation of **§351. The transfer is completely taxable to Norm.**

- **Would it affect the transfer if Norm were related to either Jay or Karen, or both, and the transfer resulted in Norm constructively owing 80% or more of the stock of Video? Perhaps Jay and Karen are his children, and he would be treated as the owner of all of their stock for several purposes in the tax law.**

■ **Discussion:** The nonrecognition rule of **§351** does not use any constructive ownership in measuring the minimum 80% control. **§368(c),** which defines control as 80% of the stock, similarly does not use any constructive ownership rules. Therefore, Norm would still be required to recognize this gain.

- **What are the tax consequences to Norm and Video if the entity is an LLC?**

■ **Discussion:** Under the partnership rules, any person who transfers property to a partnership in exchange for an interest therein does not recognize gain or loss on the transfer of the property. Therefore, Norm would not recognize gain on the transfer of the lot to Video. Norm's basis in his interest in Video would be the adjusted basis of the lot, or $20,000. [**§722.**] The basis of the lot to Video would be $20,000. [**§723.**] In addition, the precontribution gain of $80,000 (difference between fair market value and adjusted basis at the time of Norm's contribution) must be allocated to Norm in its entirety, even though he only has a 20% interest on other partnership items. [**§704(c).**] Thus if Video should ever sell the lot, the first $80,000 of gain would be reported by Norm on his tax return for the year of sale by the company.

SITUATION 5: *Allen, Michelle and Vanessa formed AMVCO this year. They are equal owners. For their interests, Allen contributed $50,000 cash, while Michelle contributed property worth $100,000 (basis $30,000), which is subject to a mortgage of $50,000 that AMVCO assumed. Vanessa contributed property worth $50,000 and an adjusted basis of $15,000. Allen and Michelle received common stock. Vanessa received preferred stock. Her stock does not participate in growth of the company, and she has a right to demand that the company repurchase the stock at its fair market value five years after the contribution to the company.*

- **What are the tax consequences to the parties if the entity is a C corporation?**

■ **Discussion:** In this situation, all of the persons involved have transferred property to the corporation in exchange for stock therein. They own 100% of the stock after the transfer. Therefore, they are in control of the corporation within the meaning of **§351.** However, this is not a "pure" **§351** transfer for two reasons:

1. AMVCO assumed a mortgage from Michelle. Therefore, she has received consideration other than stock.
2. Vanessa's stock meets the definition of "nonqualified preferred stock," which **must be treated as boot pursuant to §351(g).**

The assumption of Michelle's liability could result in all of the liability, or part of the liability being treated as boot. If there were any tax avoidance purpose in the assumption of the debt, or if the assumption had no business purpose, the **entire $50,000** would be treated as boot, and **would require Michelle to recognize gain to the extent of the $50,000.** [**§357(b).**] Note that the entire $50,000 would be treated as boot if any of the liability were assumed for the wrong reasons. For instance, if there were a business purpose to the assumption of $49,000, but Michelle had refinanced the property before contribution for $50,000 and had pocketed $41,000 cash, the entire $50,000 would be treated as boot. In this instance Michelle would recognize gain of $50,000, the corporation would take a basis of $80,000 (her basis of $30,000 plus the gain of $50,000) in the property contributed by Michelle. Michelle would take a basis of $30,000 in her stock–her original basis in the property of $30,000, plus the gain recognized of $50,000, less the liability assumed of $50,000.

If there were a business purpose, and no tax avoidance motive in the assumption of the liability, Michelle would still have a problem. When the amount of liability assumed from a shareholder **exceeds** that person's basis in the contributed property in a **§351** exchange, the **excess of the liability** over basis must be treated **as boot.** [**§357(c).**] If this were the case Michelle would recognize **$20,000 of gain** ($50,000 mortgage less the property's adjusted basis of $30,000). The corporation would add that gain to the precontribution basis of the property, and the **basis** to the corporation would be **$50,000.** Michelle's basis in her stock would be zero ($30,000 basis in property plus $20,000 gain recognized less $50,000 liability assumed). Michelle **could cure this recognition** of gain by contributing additional property, including cash, with a basis of at least $20,000, so that the total liability assumed from Michelle in the exchange did not exceed her aggregate basis in all property transferred. **To do so, however, would result in a shift of the economics of the arrangement of all of the parties.** If she were to do so, she would need assurances that her shares would represent more than 1/3 of the equity, or that the other shareholders also make additional contributions.

Vanessa has another problem. Although she has received stock in exchange for property, this type of preferred stock appears to be "disqualified preferred stock." This type of stock exists where there is a condition that either the shareholder or the corporation may demand that the stock be redeemed. [**§351(g),** added by the Taxpayer Relief Act of 1997.] Accordingly, she is treated as having received boot for the **entire fair market value of the preferred stock.** She would thus recognize all gain on the property transferred to the corporation. Her basis in the stock would be its fair market value of $50,000. The corporation would take a basis in the property contributed by Vanessa of $50,000.

Note: Her stock still counts as stock for purposes of determining control of the corporation. Since she has transferred property and received stock, her ownership of stock is aggregated with that of the other shareholders. **Thus, her receipt of boot would not disqualify any of the other shareholders from §351 treatment.**

- **Could AMVCO be an S corporation?**

■ **Discussion:** The corporation could not be an S corporation. An S corporation may have only one class of stock outstanding. **[§1361(b)(1)(D).]** The stock issued to Vanessa clearly **violates** this rule.

- **What are the tax consequences to the parties if the entity is an LLC, and the ownership units have the rights described for the stock if the company is a corporation?**

■ **Discussion:** Allen and Vanessa would appear to have no problem with this transfer. Therefore Vanessa would recognize no gain on the transfer, assuming that her partnership interest is a valid partnership interest under local law. From the appearance, she may be a limited partner. **It makes no difference whether a transferor of property in exchange for a partnership interest is a general partner or a limited partner.** [It might affect her share of partnership liabilities, which could indirectly affect some to the other partners.]

Again, Michelle could have some problems. If the liability assumed was a "nonqualified liability," she could be treated as having **sold** all or part of the property to the partnership, rather than having contributed the property in exchange for an interest in the partnership. [**§707(a), Regulations §1.707-5.**] If it were not a "nonqualified liability," she would still face some complexities and recognition problems. Although the recognition problems are not as harsh as those associated with corporations, they are a bit more complicated.

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In general, **the first step is** to figure out Michelle's share of the partnership's liabilities. Apparently, it will be 1/3, since the three persons are all equal partners. [See the 1994 Farm Income Tax School Book for a description of shares of partnership liabilities and changes therein.]

Since partners share in liabilities of a partnership, there are two important rules to remember. First is that an increase of a partner's share of partnership liabilities is treated as a contribution of cash by the partner. [**§752(a).**] **Second,** and conversely, a partner's decrease in partnership liabilities is treated as a distribution of cash to the partner. [**§752(b).**] Thus, when the partnership assumes $50,000 of Michelle's debt, Allen and Vanessa are each treated as contributing their shares ($16,666.67 each or $33,333.33 in total) to the partnership. This would cause an increase in basis to each of these persons. Michelle, in contrast, is treated as being relieved of $33,333.33 in the form of a cash distribution.

In general, cash distributions are not taxable to partners. [**§731(a).**] However, if a distribution of cash exceeds a partner's basis the **excess is taxable.** Thus it appears that Michelle will have a taxable distribution of $3,333.33–the amount by which her liability relief exceeds her basis in the property contributed to the partnership. The character of this gain is generally capital, although there may be some problems if it relieves her of a portion of the partnership's unrealized receivables or substantially appreciated inventory items. [**§751(b).**] See the 1995 edition of the Farm Income Tax School Book for discussion.

Assuming that Michelle is not relieved of any unrealized receivable or substantially appreciated inventory items, she reports $3,333.33 of **capital gain** as a result of the contribution of property and reduction of liabilities. Her basis in her partnership interest is zero ($30,000 of property contributed, plus $3,333.33 of gain recognized less $33,333.33 of liabilities reduced.) The partnership's beginning basis in the property is Michelle's basis of $30,000. It is not increased by the gain recognized by Michelle unless the partnership has a **§754** election in effect. This election would allow the partnership to step up the basis in partnership property when a partner reports a gain as a result of a cash distribution. [**§734(b).**] It also applies to other distribution situations, and to changes in partnership interests as a result of a sale or death. [**§743(b).**]

If Vanessa is a **limited partner,** and has no share of the partnership liability contributed by Michelle, then the result is to **relieve** Michelle of the reportable gain. Her liability relief, assuming that Allen and Michelle are equal general partners, would be $25,000. Since that amount does not exceed her basis in the property she reports no gain. Her basis in her partnership interest would be $5,000 ($30,000 basis in contributed property less $25,000 liability relief.

Note: Even if all parties were general partners with the general sharing of 1/3 each in partnership liabilities, Michelle would not necessarily recognize gain on the deemed distribution of cash. She could indemnify one or both of the other partners for a portion of the liability, and keep her liability relief below $30,000, so that it **did not** exceed her basis in the contributed property.

If Michelle had incurred the liability with a tax avoidance motive, or the partnership assumed the liability with no business purpose, **the amount by which Michelle's portion of the debt is reduced is treated as a "disguised sale" of the contributed property.** Assuming that this is the case, and that her share of the liability is 1/3, she would be treated as having received $33,333.33 of cash (the other partners' combined portions of the liability). **This cash would be treated as realized in a taxable sale of a portion of the property.** In this case the cash would be 1/3 of the value of the property. Therefore, she would be treated as selling 1/3 of the property and contributing 1/3 of the property to the partnership in exchange for an interest therein. **She would bifurcate the transaction as follows**:

	Contributed	Sold	Total
Fair market value	$66,667	$33,333	$100,000
Percent	66.67%	33.33%	100%
Amount realized	$66,667	$33,333	$100,000
Adjusted basis	(20,000)	(10,000)	(30,000)
Gain realized	$46,667	$23,333	$70,000
Treatment	deferred	recognized	

The limited liability company would treat itself as if it had purchased 1/3 of the property for its fair market value of $33,333. The remaining value was received in a contribution in which the partner's basis would carry over. In this case the basis of the contributed portion would be $20,000. Thus the basis to the partnership would be $53,333. **There would be additional problems if the property were depreciable.**

First, the depreciation on the portion deemed purchased would be treated as new MACRS property placed in service at the time of Michelle's contribution. The portion contributed, however, would use the depreciation schedule begun by Michelle. The parties would allocate the depreciation deduction for the year of the transfer based on the relative months in the year that each owned the property. The depreciation on the contributed portion would be subject to a special allocation under **§704(c),** so that the noncontributing partners would receive an allocation of tax depreciation that matched their share of book depreciation as closely as possible. [See **Regulations §1.704-3.**] The depreciation on the new MACRS property would be shared by all of the partners in accordance with the partnership agreement for sharing such items.

CHARITABLE CONTRIBUTIONS

SITUATION 6: *Fred and his son, Steve, own a company that manufactures fiber optic cable. The company uses the calendar year and the accrual method of accounting. In November, 19X1, the company decided to contribute cable worth $10,000 (basis $4,000) to a local high school for use in building a new computer lab. The company actually made the contribution in February, 19X2.*

- **Explain the tax consequences of the contribution assuming the company is a C corporation.**

■ **Discussion:** The corporation may claim a deduction for $7,000 on its 19X1 tax return, assuming that its taxable income before the contribution is **at least $70,000.** There are two important factors in this analysis. **First,** the corporation had made a timely payment. **Second,** the donation was made in **qualified property.**

■ Since the C corporation is on the accrual method of accounting it may deduct a contribution accrued, but not actually made, before the end of a taxable year. The contribution must be acknowledged in the minutes and paid in a timely fashion after year end. [**§170(a)(2).**] **The payment must be made on or before 2 months and 15 days after the close of the corporation's taxable year.** [**§170(a)(2)(B).**]

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The corporation is limited to 10% of its taxable income before the charitable contribution, dividends-received deduction and deduction of operating loss or capital loss carrybacks to the year of the contribution. [**§170(b)(2).**]

A C corporation is entitled to deduct the value less half the gross profit if the property were sold for its fair market value for certain contributions. These are limited to certain types of contributions:

1. Inventory contributed to an organization for the care of the needy, the ill, or infants.
2. Computer technology and related equipment to schools for use in grades K-12. [**§170(e)(3).**] The property must have been constructed by the corporation and must not be more than two years old at the time of the contribution.

- **Explain the tax consequences of the contribution assuming the company is an S corporation.**

■ **Discussion:** The shareholders may claim **itemized deductions** for the charitable contribution **equal to the property's basis of $4,000.** They may claim these deductions on their tax returns for 19X2, the year the contribution **was actually made.** The contribution would pass through from the corporation to its shareholders, and **would reduce each shareholder's basis in stock** to the extent thereof. If the contribution exceeded the shareholder's basis, it would still be claimed in the year passed through, and would not be carried forward merely because it exceeded a shareholder's basis. [**Regulations §1.704-1(d)(2).**] The contribution would not be limited to any portion of the corporation's taxable income, and could be deducted by the shareholder even if the corporation sustained a loss for the year.

The accrual rule and the ability to deduct more than the basis of such property are specifically denied to S corporations. [**§170(e)(3)(A).**] Moreover, a charitable contribution is disallowed to the S corporation, per se. The contribution is allocated to the corporation's shareholders in the same manner as income and other items for the taxable year in which the contribution is actually made.

- **Explain the tax consequences of the contribution assuming the company is an LLC.**

■ **Discussion:** The tax consequences to the partnership and to the partners would be generally the **same as** that described above for S corporation shareholders. **Note again** that the charitable deduction **would not** be limited to a partner's basis in his or her partnership interest, since **Regulations §1.704-1(d)(2)** limits losses to basis for all items **except** charitable contributions and foreign taxes. Also, each partner is treated as having made his or her share of the partnership contribution at the end of the partnership's year in which the contribution was actually made, regardless of the accounting method of the partnership or the partner. [**Regulations §1.703-1.**] The allocation of the contribution among the various partners would be determined by the partnership agreement. Such allocation would be respected by the IRS if it were in accordance with each partner's interest in the partnership. A contribution could be specially allocated to partners by the partnership agreement if the agreement had substantial economic effect. [**§704(b).**]

PASSIVE INCOME

SITUATION 7: *BS Company is owned and operated by two sisters, Barb and Sharon. This year the business' operating income was flat. As a result, it relied on its rental of an old strip center in Dublin and some temporary investments in securities to survive. The income picture for the year is shown below.*

Revenues from sales	$200,000	
Costs of goods sold	(190,000)	
Gross profit from operations		$10,000
Rental income	$50,000	
Rental expenses (depreciation, interest, taxes)	(30,000)	
		20,000
Interest and dividends		15,000
Income before overhead		$45,000

1. **What problems, if any, should BS be concerned about if it is a C corporation?**

■ **Discussion:** The corporation appears to fall within the category of a **personal holding company.** There are **two** tests, based on types of income and ownership. If the corporation meets both of these tests for any year, there is an additional tax imposed on the corporation's undistributed personal holding company income for that year. **The tax is in addition to the income tax and alternative minimum tax and is imposed at a rate of 39.6%.**

The income test means that at least 60% of its adjusted ordinary gross income is from personal holding company income. [**§542(a)(1).**] Adjusted ordinary gross income consists of ordinary gross income less certain deductions. Ordinary gross income is gross income less capital gains and **§1231** gains. [**§543(b)(1).**] Adjusted ordinary gross income is ordinary gross income less certain deductions attributable to rents and royalties (rents, interest, taxes, depreciation, and depletion). [**§543(b)(2).**] In this case, since there are no capital gains or **§1231** gains, the ordinary gross income is as follows:

Revenues from sales	$200,000	
Costs of goods sold	(190,000)	
Gross profit from operations		$10,000
Rental income (gross)		50,000
Interest and dividends		15,000
Ordinary gross income		$75,000

The corporation's adjusted ordinary gross income is its ordinary gross income less the rental expenses of $30,000, or $45,000.

Personal holding company income includes interest, dividends, royalties, and annuities, with certain types of interest from lending institutions and special cases excluded. [**§543(a)(1).**] It also generally includes rents, although in certain cases rents can be treated as not personal holding company income if the rent income exceeds 50% of the corporation's adjusted ordinary gross income. That test is not relevant in this case, since the adjusted income from rents is $20,000 and the adjusted ordinary gross income is $45,000. Therefore, the adjusted income from rent, interest, and dividends combined equal, $35,000. **This exceeds 60% of the adjusted ordinary gross income of $45,000. BS has met the income definition of a personal holding company.**

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The ownership test is **usually quite straightforward,** although the constructive ownership rules may make it complicated. To meet the ownership test, more than 50% of the corporation's outstanding stock is owned by five or fewer individuals (including pension trusts and private foundations) on any single day in the last half of the corporation's taxable year. [**§542(a)(2).**] The constructive ownership rules of **§544** treat stock owned by family members and intermediate entities, such as other corporation's partnerships, estates, and trusts as being owned by individuals to whom they are related. **In this case, Sharon and Barb, as sisters, would be treated as one owner. Therefore BS Corporation is a personal holding company for the current year.**

2. **What problems, if any, should BS be concerned about if it is an S corporation that formerly was a C corporation?**

■ **Discussion:** In general, there are no restrictions on the types of income that an S corporation may produce. However, there are certain problems with some former C corporations. **If an S corporation has any accumulated earnings and profits, its gross receipts from passive investment income cannot exceed 25% of its gross receipts from all sources, or there could be two unfortunate results. First,** the corporation would pay a corporate level tax of 35% on its excess net passive investment income. [**§1375.**] **Second,** if the situation persists for three consecutive years, the corporation loses its S election as of the first day of the next year. [**§1362(d)(3).**]

In this case, there is not sufficient information to determine if there are any accumulated earnings and profits. In practice, a tax return rarely yields sufficient information to determine the amount of accumulated earnings and profits, since there is no requirement that a C corporation or S corporation ever report this amount on its tax return. In general, there are probably accumulated earnings and profits if the corporation has been a C corporation and has retained earnings in excess of its AAA.

An S corporation's passive investment income **includes** gross receipts from interest, dividends, annuities, rents, royalties, and gains from sale of stock and securities. **There are several exceptions to most of these categories.** In this case it appears that the gross receipts from rents interest and dividends are $65,000. Its gross receipts from all sources are $265,000, including these passive sources plus the gross receipts from sales. **Therefore, the corporation could have up to $66,250 of passive investment income this year without creating any problems.** It is close to that amount but not over the limit. Therefore, it has no liability for the passive investment income tax this year. Moreover, this year's gross receipts will not endanger its continued S election.

In this situation, the rents would most likely pass through to the corporation's shareholders as passive activity income, and could be offset by losses from other passive activities. [**§469.**] The interest and dividend income would be portfolio income to the shareholders. This income **could not be offset** by passive activity losses, but would add to the ceiling for deductibility of investment interest. The net income from its other operations would be **passive activity income** to any shareholder **that did not materially participate** in the corporation's business activities, but would not be passive activity income to a shareholder that did materially participate.

3. **What problems, if any, should BS be concerned about if it is an S corporation which was never a C corporation?**

■ **Discussion:** An S corporation does not generate any earnings and profits while its S election is in effect. **Therefore it is rare for such a corporation to have any problems with passive investment income.** It is possible for an S corporation to acquire accumulated earnings and profits if it acquires a C corporation or former C corporation in a tax-free reorganization or liquidation. One way in which this might happen is if an S corporation acquires 100% of another corporation and elects to have the subsidiary corporation treated as a Qualified Subchapter S Subsidiary. [**§1361(b)(3).**] This election treats the subsidiary corporation as if were liquidated in a tax-free liquidation under **§332** into the parent S corporation. When a C corporation's existence terminates in a tax-free reorganization or liquidation, the extinguished corporation's assets bases carry over to the survivor. [**§334(b).**] Similarly, its earnings and profits and other attributes survive. [**§382.**]

If BS has never been through one of these transactions, it **would not have any** accumulated earnings and profits. **Therefore, it would have no passive investment income worries.** Its various items of income and loss would pass through to the shareholders in the same manner described in 2, above.

4. **What problems, if any, should BS be concerned about if it is an LLC?**

■ **Discussion:** A partnership, including an LLC, **has no entity level passive investment income problems,** nor does it face any possible treatment as a personal holding company. Its income would flow through to the members subject to the same characterization rules as those discussed above under #2. In addition, the ordinary income from the business would flow through as self-employment income to any person who is treated as a general partner under the tax law. A partnership has more flexibility in allocating the amounts of specific items to its owners than does an S corporation. An S corporation must generally allocate every line item ratably to its shareholders based on weighted average share holdings for the entire year. [**§1377(a)(1).**] An S corporation may have an interim closing upon the termination of a shareholder's interest in the corporation, a substantial disposition of stock, or issuance of a substantial amount of new stock [**(§1377(a)(2), Regulations 1.1368-1(g).)**]

A partnership, by contrast, may allocate items of income in accordance with the partnership agreement. [**§704(a).**] However, in order to be respected by the IRS, the agreement must be in accordance with each partner's interest in the partnership, or it must have substantial economic effect. [**§704(b).**] Allocation in accordance with each partner's interest in the partnership generally leaves little flexibility in the allocation of specific items. **For example, it would not allow BS to allocate a different percentage of ordinary income to Barb from her percentage of interest and dividend income.** If an allocation has substantial economic effect, however, the partnership could allocate different line items in different proportions to its partners. The record keeping requirements for substantial economic effect are onerous and complicated, but they do provide flexibility. [See **Regulations §1.704-1(b).**]

ALLOCATIONS OF INCOME TO OWNERS

SITUATION 8: *Splitco has three owners, Laura, Marvin, and Norma, all of whom own equal interests in the business. This year, Splitco wants to allocate 60% of its income to Laura and 20% each to the other two. Its income is expected to be $100,000 for the current year.*

- **Is there any way the business can accomplish this objective if it is an S corporation?**

■ **Discussion:** There is **no way** to allocate income among owners directly in any proportion other than the weighted average ownership of shares of each holder throughout the year, unless there is a change in ownership during the year. [**§1377(a)(1).**] If the parties want to achieve this economic objective, they could draw up special compensation agreements, and pay salary or bonuses to the one owner who wants to get 60% of the profits. For the current year, the corporation could pay Laura a salary of $40,000 (if reasonable), which would leave net income of $60,000 to be split three ways. Thus Laura would wind up with her salary of $40,000 plus her share of income of $20,000 for the desired total of $60,000. The other two would each have 1/3 of the $60,000 net income for $20,000 each.

- **Is there any way the business can accomplish this objective if it is a partnership?**

■ **Discussion:** There are **two possible ways** to accomplish this objective in a partnership. The partnership could use a **guaranteed payment** to Laura, in the same manner that the S corporation used a salary payment. This is undoubtedly the simplest way to accomplish this objective. The partners would approve a guaranteed payment of $40,000 to Laura, and split the remaining $60,000 of net income in three equal proportions.

The other, and more complicated, way to accomplish this objective is to allocate the income 60% to Laura and 20% each to the other two partners in the partnership agreement. To achieve the desired result **(without readjustment by the IRS**) the agreement must have **substantial economic effect.** To achieve this result, the agreement must first have **economic effect.** This rule requires that any allocation of each tax item must be matched by economic burden or benefit. [**Regulations §1.704-1(b)(2)(ii)(a).**]

- There are three tests which the partnership must satisfy. [**Regulations §1.704-1(b)(2)(b)(ii)(B).**]
- The partnership must maintain capital accounts for each partner in accordance with **Regulations §1.704-1(b)(2)(iv).**
- Upon liquidation of the partnership, each partner must receive liquidating distributions in accordance with his or her positive capital account balance.
- Any partner who has a deficit in his or her capital account at the time of liquidation must be **obligated** to repay the partnership in the amount of the deficit.

To meet this test in this case, the partnership would need to post $60,000 to Laura's capital account and $20,000 each to the other two. The result must be that Laura is entitled to receive $60,000 of partnership assets upon dissolution of the partnership, whereas the other two may only receive $20,000 each as a result of this year's income. If the partnership had been in a deficit situation, Laura would have $40,000 less of an obligation to restore the deficit than would the other two. Thus Laura would receive the economic benefit of the income allocated to her.

DISTRIBUTIONS OF CASH AND PROPERTY

SITUATION 9: *ZM is owned and operated by Zac and Molly. Each owns a 50% interest in the business and have a basis for their interest of $30,000. This year the company distributed a nonliquidating distribution of cash to each of $50,000. What is the effect on the business and the owners if the business is a C corporation?*

■ **Discussion:** The entire $50,000 to each shareholder would be a **dividend** if the corporation had sufficient current earnings and profits or accumulated earnings and profits to cover the amount. In most cases, a corporation with sufficient cash flow to make a distribution to its shareholders probably has earnings and profits to cover the distribution.

"Earnings and profits" is the term given to the amount of the distribution that a corporation can distribute without impairing its capital account. It measures the extent to which a distribution is made out of the corporation's economic income as opposed to its taxable income or its paid-in capital. "Earnings and profits" (E&P) is not defined in the Code and it has no counterpart in the area of corporate law or financial accounting. **It is not the same as retained earnings or earned surplus. Revenue Procedure 75-17, 1975-1 CB 677,** provides a summary of the general information that must be maintained by a corporation, including sample computations and schedules that illustrate a detailed year-by-year analysis of E&P. The IRS has indicated that it will not issue private letter rulings or determination letters regarding the computation of E&P (**Rev. Proc. 98-3,** 1998-1 IRB 100). As a practical matter, few corporations actually compute earnings and profits regularly. The computation is not necessary in order to file a proper Form 1120. The balance sheet and other schedules on Form 1120 **do not even provide a place to show the calculation.**

Current E&P is computed by starting with the corporation's current taxable income or loss and making certain adjustments some of which are prescribed in **§312**. For purposes of computing E&P, taxable income is computed using the same accounting method normally used by the taxpayer (e.g., the cash or accrual method) [**Reg. Sec. 1.312-6(a)**]. There are several adjustments that must be made to taxable income to arrive at current E&P.

1. Taxable income is increased by items of income which are excluded or which may be deferred (e.g., tax-exempt income and installment sale income but not gain deferred under the like-kind exchange provisions of **§1031** or involuntary conversion rules of **§1033**) [**Secs. 312(n)(5)** and **(f)(1)** and **Reg. Sec. 1.312-7(b)**]. However, losses not recognized under **§267** do reduce E&P [**Reg. Sec. 1.312-7(b)**].
2. Taxable income is increased by certain artificial deductions (e.g., the dividends received deduction).
3. Taxable income is reduced by expenses and losses which are not deductible in computing taxable income but which reduce the corporation's ability to pay dividends (e.g., federal income taxes, capital losses).
4. For depreciable property acquired for tax years beginning after June 30, 1972, and placed in service before 1981, the excess of accelerated depreciation over straight-line depreciation (i.e., only straight-line is allowed). For recovery property placed in service in tax years beginning after December 31, 1980, and before January 1, 1987 (e.g., 1981–1986), which is depreciated using the original version of ACRS, depreciation is limited to that using the straight-line method using extended recovery periods and the half-year convention.

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5. Post-1986 depreciation for E&P purposes is computed under the alternative depreciation system (ADS as defined in **§168(g)**), using the straight-line method and the asset's ADR midpoint life (unless another life is prescribed or if no life is prescribed, 12 years for personal property and 40 years for real property) [**§312(k)(3)**].
6. The gain or loss realized on a disposition of property for E&P purposes normally will differ from that computed in arriving at taxable income since E&P depreciation for such property differs from tax depreciation [**Reg. Sec. 1.312-7(a)**].
7. For years beginning after 9/30/84, each corporation must make adjustments to its taxable income to reflect "economic income" pursuant to **§312(n)**. Under these rules, construction period interest and taxes must be capitalized as part of the asset to which they relate and amortized over the asset's recover period that is used for E&P purposes [**§312(n)(1)**]. Intangible drilling costs must be capitalized and amortized ratably over 60 months beginning with the month in which the amount was paid or incurred [**§312(n)(2)(A)**]. Mineral exploration and development costs must be capitalized and amortized ratably over 120 months beginning with the later of the month in which production begins or the month in which the costs were paid or incurred [**§312(n)(2)(B)**]. Organization [**§248**] and circulation expenditures [**§173**] may not be amortized but must be capitalized [**§312(n)(3)**]. E&P must be increased or decreased by changes in the LIFO recapture amount which is generally the excess of FIFO over LIFO [**§312(n)(4)**]. There is no change in earnings and profits for a reduction in the LIFO reserve, to the extent the reserve had accumulated in a year beginning before 9/30/84. The corporation may not use the installment method in computing earnings and profits. [**§312(n)(5)**]. This requires an upward adjustment in the year of an installment sale and downward adjustments in years of collection. Note that this rule applies to the few installment sales permitted under post-1986 law. It also covers installment sales of dealer property in years when the installment method was allowed.

Note: Current E&P is computed without regard to distributions made during the year [**§316(a)**]. Accumulated E&P is the sum of current E&P for all taxable years reduced by distributions, including the allocable charge to E&P for any stock which is redeemed.

If a distribution **exceeds** the corporation's current and accumulated earnings and profits it is treated as a reduction of the shareholder's basis to the extent thereof. Any amount in excess of earnings and profits and basis is treated as a gain from the sale of stock. **Therefore, we may consider three possibilities for this situation:**

1. The corporation's earnings and profits is at least $100,000. In this situation Zac and Molly each report dividend income of $50,000. There is no effect on either shareholder's stock basis.
2. The corporation's earnings and profits is $80,000. In this situation Zac and Molly each report dividend income of $40,000. They each **reduce basis** by $10,000, so that their basis after the distribution is $20,000 each.
3. The corporation's earnings and profits is $30,000. In this situation Zac and Molly each report dividend income of $15,000. They each **reduce basis** by $30,000, so that the basis of each shareholder after the distribution is $0. Each shareholder still has **$5,000** distribution to account for. **Each would report $5,000 as a capital gain.**

SITUATION 9 (continued) *What is the effect on the business and the owners if the business is an S corporation that was formerly a C corporation? Assume that the business has substantial retained earnings.*

■ **Discussion:** The presence of retained earnings indicates that the corporation has accumulated earnings and profits from years in which it was a C corporation. For these situations, **Code §1368(c)** provides a three-tiered hierarchy of distribution rules:

1. The corporation's Accumulated Adjustments Account (AAA) is the **first source of distributions.** Distributions **which do not exceed** the AAA **are tax-free** to each shareholder **to the extent** of his or her stock basis, with any excess treated as a **gain** from the sale of stock.
2. Once AAA is exhausted, **distributions are treated as dividends to the extent of the corporation's accumulated earnings and profits.** These dividends are taxed in the same manner as those from a C corporation. They are ordinary portfolio income and have no effect on any shareholder's stock basis.
3. After accumulated earnings and profits are exhausted, the corporation is now **subject to the rules for S corporations** with no accumulated earnings and profits–distributions are **tax free** reductions of shareholder **basis** to the extent thereof, with any excess treated as a **gain from the sale of stock.**

The two critical corporate level accounts are the AAA and the accumulated earnings and profits. The accumulated earnings and profits were determined when the corporation was a C corporation, under all of the rules discussed above. After the S election takes effect, the corporation gains no new earnings and profits unless it acquires another C corporation in a tax-free reorganization or liquidation. **The AAA computations are unique to S corporations.**

The AAA is a corporate level account, with no specific portion being assigned to any particular shareholder or traced to any particular year. **It is increased** in the amount of all of the taxable income items that flow through to the shareholders. It **does not** reflect any tax-exempt income of the corporation. It is **reduced** for corporate expenses and losses, whether or not they are deductible. Thus it is reduced for such items as the 50% disallowance of meal and entertainment expense. It is **not reduced** for any expense associated with tax-exempt income, such as interest paid to carry a municipal bond portfolio, or premiums on officer's life insurance carried by the corporation. [**§1368(e).**]

For this situation consider several possibilities:

1. The corporation's AAA is at least $100,000. Each shareholder would treat $50,000 as a reduction of basis to the extent thereof ($30,000) and treat the remaining $20,000 **as gain** from the sale of stock.
2. The corporation has no AAA, but has accumulated earnings and profits of at least $100,000. Each shareholder would treat the distribution as $50,000 of **ordinary dividend income.**
3. The corporation has $50,000 AAA and $100,000 accumulated earnings and profits. The shareholders would each reduce basis by $25,000 (50% of the AAA) and report the remaining $25,000 as **dividend income.**
4. The corporation has $48,000 AAA and $32,000 accumulated earnings and profits. The shareholders would each treat their distribution from the AAA as a $24,000 reduction of basis, leaving each shareholder with $6,000 of basis at this point. They would then each report $16,000 of dividend income, with no effect on basis. The remaining $10,000 would reduce basis by $6,000, down to zero, and the final **$4,000 would be treated as a gain from the sale of stock by each shareholder.**

SITUATION 9 (continued): *What is the effect on the business and the owners if the business is an LLC?*

■ **Discussion:** Under general rules each partner would **reduce basis** to the extent thereof ($30,000) and report the remaining $20,000 as a **gain from the sale of his or her partnership interest.** [**§731(a).**] The partners should be on the lookout for some special rules that might apply to either or both.

If either partner received this distribution **within two years of a contribution of property,** there is the possibility that the distribution could be consideration received in a disguised sale of the contributed property to the partnership. [See the discussion above, concerning Allen, Michelle, and Vanessa.] In this case the distribution would have an interest component, reflecting the time value of money for the delay between the contribution and the distribution. The remaining portion of the distribution would be the principal payment made for the portion of the property deemed to be sold to the partnership under the disguised sale rules. [See **Regulations §1.707-3.**] There are certain exceptions, whereby distributions that do not exceed a partner's share of operating cash flows are not treated as consideration from a disguised sale. It may also be possible to rebut the presumption that the distribution was part of a disguised sale.

SITUATION 10: *BK is owned and operated by Bobby and Kelly. Each owns a 50% interest in the business and have a basis for their interest of $30,000. This year the company distributed a parcel of land to each owner worth $50,000 (basis $10,000). Assume that the business has substantial retained earnings.*

- **What is the effect on the business and the owners if the business is a C corporation?**

■ **Discussion:** The C corporation would treat the **noncash** property distribution in a manner similar to a cash distribution, except that the **C corporation would also recognize a gain of $40,000 on the distribution of each parcel.** [**§311(b).**] Note that there is no converse rule. If the corporation's adjusted basis had exceeded its fair market value, the corporation would **not have been allowed** to recognize a loss. [**§311(a).**] The gain **would increase** the corporation's earnings and profits in the same manner as any other income item. The corporation would then reduce its earnings and profits for the fair market value of the property distributed to the shareholders. [**§312(a)(3), §312(b)(2).**] The corporation would not reduce its earnings and profits below zero for the distribution. If the fair market value of the property exceeded the current and accumulated earnings and profits after including the gain from the distribution, the corporation **would reduce paid-in capital for the excess.**

The shareholders would be treated as receiving a distribution of the fair market value of the property, or $50,000 each. [**§301(b)(1).**] They would treat this fair market value exactly as if they had received cash, as in the earlier situation with Zac and Molly. Thus, to the extent that the fair market value of the distributed property did not exceed the corporation's earnings and profits they would report **dividend income.** [**§301(c)(1).**] Any excess would reduce each shareholder's basis to the extent thereof. [**§301(c)(2).**] If the basis were to be exhausted, any remaining amount of the distribution would be treated as a **gain from the sale of stock.** [**§301(c)(3)(A).**]

- **What is the effect on the business and the owners if the business is an S corporation that was formerly a C corporation? Assume that the business has substantial retained earnings.**

■ **Discussion:** This situation would resemble the above case where the corporation was a C corporation. All corporations whether C or S, must recognize gain on the distribution of noncash property to shareholders. [**§311(b).**] The contrast to the C corporation comes with the effect of the gain. Rather than increasing the corporation's earnings and profits it would flow through to the shareholders. It would increase AAA, and simultaneously increase each shareholder's stock basis. [**§1366(a)(1), §1368(e)(1)(A).**] **Consider the following situations.**

1. The corporation's AAA is at least $20,000, before considering any aspects of the distribution. The corporation would increase its AAA by $80,000 ($40,000 on each piece of property). After this gain, the AAA would be at least $100,000. Therefore, the distribution would not exceed the AAA, **and would not be a dividend.** Each shareholder would increase basis from $30,000 to $70,000 as a result of the gain. They would each then reduce basis for $50,000 to reflect the distribution of the property. Each shareholder would take a basis of $50,000 in the property received.
2. The corporation has zero AAA but has accumulated earnings and profits of at least $100,000 before the distribution. The corporation would increase its AAA to $80,000 as a result of the gain on the distribution. Thus $40,000 of each shareholder's distribution would come from the AAA. The remainder would come from the corporation's accumulated earnings and profits and would reduce that account to $80,000. Each shareholder would increase basis to $70,000 as a result of the gain. Each shareholder would then reduce basis for the $40,000 portion of the distribution that came from the corporation's AAA. The remaining $10,000 to each shareholder would be **dividend income.**
3. The corporation has $100,000 deficit in AAA before any effects of the distribution, and has $100,000 accumulated earnings and profits. The corporation would reduce its deficit in the AAA to $20,000 as a result of the gain. There still would be no AAA balance, so the entire distribution would be treated as a dividend from the corporation's accumulated earnings and profits.

- **What is the effect on the business and the owners if the business is an LLC?**

■ **Discussion: In most cases, a partnership does not recognize any gain on the distribution of property to a partner.** [§731(b).] **Similarly the partner who receives the distribution recognizes no gain on the distribution, even if the fair market value of the property exceeds the partner's basis in his or her partnership interest.** [§731(a)(1).] **This is in marked contrast to the S corporation rules,** which require the corporation to **recognize gain** on the distribution of appreciated property in the same manner as a C corporation. The partner who receives the distribution takes the partnership's predistribution basis in the property into account. [**§732(a)(1).**] The partner reduces basis in the partnership interest by this amount, unless the partner's predistribution basis in the partnership interest was less. In that case the partner reduces his or her basis in partnership interest to zero. [**§733(2).**]

If the distributions to the two partners came under this general rule, each partner would reduce basis in his or her partnership interest by $10,000–the partnership's predistribution adjusted basis in the property distributed. This same amount would become each partner's basis in the property received. However, there are several **complicated exceptions** to this general rule. **Consider several independent possibilities.**

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1. Bobby received the distribution within two years after a **major contribution** of property. This distribution could be treated as consideration received in a **disguised sale** of the "contributed" property to the partnership. [See discussion above.]
2. The property received by Kelly had been contributed to the partnership by Bobby **within seven years** before the date of the distribution. **At the time of the distribution to Kelly, Bobby would recognize any precontribution gain that would have resulted if he had sold the property at the time of contribution.** [**§704(c)(1)(B).**] Further assume that the fair market value of the property at the time it was contributed was $35,000 and its basis to Bobby at the time of contribution was $10,000. At the time of distribution to Kelly, **Bobby must recognize $25,000 of gain,** as if he had sold the property to the partnership for its fair market value at the time of contribution. [**§704(c)(1)(B).**] As a result of this gain recognition, the partnership will **increase the basis** of the property by the gain **recognized** by Bobby. The property will have a predistribution basis of $35,000. **Thus Kelly will take the lesser of the partnership's**

basis in the property ($35,000) or her predistribution basis ($30,000) as the basis in the property distributed. Thus Kelly will take a basis of 30,000 in the property and must reduce basis in her partnership interest to zero. [**§704(c)(1)(B)(iii).**] Bobby will also increase his basis in his partnership interest to reflect the **gain recognized** as a result of this transfer. [**§704(c)(1)(B)(iii).**] Thus Bobby's basis in his partnership interest will increase from $30,000 to $55,000.

3. Bobby received his property within seven years after contributing other property to the partnership and the transactions, when taken together, did not constitute a disguised sale. At the point in time Bobby received the distribution, **he would need to recognize any precontribution gain on the property he had contributed as if the property he had contributed were distributed to another partner.** [**§737.**] Assume the same facts as in 2, above, except that the property received by Kelly was not contributed by Bobby. Instead, she received another partnership asset and the property contributed by Bobby stayed with the partnership. **Bobby** would **recognize $25,000** of gain when he received the property from the partnership. As a result of this gain, both Bobby's basis in his partnership interest, and the partnership's basis in the property contributed by Bobby would be **increased** by $25,000. [**§737(c).**]

4. **Finally,** assume that the property received by Bobby was an inventory item of the partnership and the property received by Kelly was not an inventory item, but was a capital asset to the partnership. The distributions would have altered each partner's interest in the partnership's unrealized receivables and substantially appreciated inventory items. **Thus §751(b) would treat each distribution as if it were partly a fully taxable sale.** Although the steps are rather lengthy and complicated, the results would be approximately the same as if each partner has received a 50% interest in each piece of property and then sold the interest to the other partner. Bobby would have hypothetically received a 50% interest in the capital asset. The basis at the time of this hypothetical distribution would be the partnership's basis of $45,000 in 50% of the asset. He would then have sold the 50% interest to Kelly at its fair market value of $25,000. **Thus Bobby would recognize $20,000 of capital gain on the hypothetical sale. Kelly would have received a 50% interest from the partnership as a distribution and would have purchased the other 50% from Bobby.**

The distribution to Bobby would be a mirror image of the distribution to Kelly. She would have received a hypothetical distribution of 50% of the property actually received by Bobby. She would claim a $5,000 basis in that property and would then immediately resell her interest to Bobby at its fair market value of $25,000. Since the property received by Bobby is an inventory item, Kelly's gain on the sale would be **ordinary income.** [**§751(b).**] **The tax treatment to the two parties is summarized below:**

	Kelly	Bobby
Basis in 50% received in initial hypothetical distribution	$ 5,000	$ 5,000
Basis in property hypothetically purchased from other property	25,000	25,000
Basis in property received	$ 30,000	$ 30,000
Basis of partnership interest before distribution	30,000	30,000
Reduction for 50% of property actually received	(5,000)	(5,000)
Reduction for 50% of property hypothetically received	(5,000)	(5,000)
Basis after distribution	$ 20,000	$ 20,000
Proof: total predistribution basis in partnership interest	$ 30,000	$ 30,000
Gain recognized	20,000	20,000
Total to account for	$ 50,000	$ 50,000
Basis in partnership interest	$ 20,000	$ 20,000
Basis in property received	30,000	30,000
Total	$ 50,000	$ 50,000

RETIREMENT PLANS

SITUATION 11: *Martha and Adrienne are equal owners of an active business. In the current year, the business has $120,000 of taxable income and cash flow, before considering any distributions, compensation to the owners, or contributions to a retirement plan.*

- **What if the business was operated as a limited liability company, and allocated $60,000 of the taxable income to each member? Would the business be able to make any contributions to a qualified retirement plan? What would be the net effect on taxable income to the business and to Martha and Adrienne?**

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■ **Discussion:** The partnership **could not maintain a qualified pension plan per se,** although it could maintain a self-employed retirement ("Keogh") plan. It could contribute up to 20% of each partner's self-employment income to the plan, with an approximate upper limit of $30,000 per person. In this situation it could contribute $12,000 on behalf of each partner. Each partner would then deduct her Keogh contribution on page 1 of her Form 1040. Thus each partner would report net taxable income of $48,000 for the year due to partnership income.

However, the partners need to consider self-employment tax ramifications of this arrangement.

Since the Keogh plan deduction is a page 1 deduction it does not reduce a partner's self-employment income. Therefore each partner would have $60,000 of self-employment income. After the limited liability company made the contribution to the Keogh plan it would have approximately $96,000 cash flow, which could be distributed to the two members.

- **What if the business were operated as a C corporation and distributed $48,000 to each partner as a salary? Would the business be able to make any contributions to a qualified retirement plan? What would be the net effect on taxable income to the business and to Martha and Adrienne?**

■ **Discussion:** In this case the corporation could establish a qualified pension plan and contribute up to 25% of the compensation to each owner. Thus it could contribute up to $12,000 on behalf of each shareholder to the plan. Each shareholder's taxable income and FICA income would be $48,000. The combination of the salary and the pension contribution would reduce the corporation's taxable income to zero.

- **What if the business were operated as an S corporation and distributed $48,000 to each partner as a salary? Would the business be able to make any contributions to a qualified retirement plan? What would be the net effect on taxable income to the business and to Martha and Adrienne?**

■ **Discussion:** **In this case the results would be identical for an S corporation and a C corporation.** The corporation could establish a qualified pension plan and contribute up to 25% of the compensation to each owner. Thus it could contribute up to $12,000 on behalf of each shareholder to the plan. Each shareholder's taxable income and FICA income would be $48,000. The combination of the salary and the pension contribution would reduce the corporation's taxable income to zero.

SITUATION 12: *Refer to Situation 11. The business becomes extremely profitable, and earns $2,000,000 in one year, before considering income tax and the compensation to the two principals.*

- **What would be the tax implications if the business were a limited liability company?**

■ **Discussion:** The limited liability company could contribute up to $30,000 on behalf of each member to the Keogh plan. The remaining income would be self-employment income to the members, whether or not it was distributed.

- **What would be the tax implications if the business were a C corporation?**

■ **Discussion:** The corporation could contribute up to $30,000 on behalf of each shareholder to the pension plan. Any amounts distributed as salary would be subject to tax at the **shareholder-employee level,** including the retirement and Medicare portions of FICA. The corporation would also need to pay FICA tax on the salary. Any amount retained by the corporation would be subject to the corporate income tax at a rate of 34%. In addition, the retained earnings could be subject to the accumulated earnings tax or the personal holding company tax, depending on the nature of the business. The C corporation faces one other possible challenge if it tries to pay out all of its earnings as salaries to the two shareholder-employees. A corporation's deduction for compensation is limited to that which is "reasonable in amount". [**§162.]**

Any compensation in excess of a reasonable level could be subject to treatment by the IRS as a constructive dividend. Such treatment would still leave the shareholders with gross income, but deny the corporation the deduction, and impose the corporate tax at the 34% rate.

- **What would be the tax implications if the business were an S corporation?**

■ **Discussion: For these circumstances, the S corporation seems to be the best choice in tax entity.** The income would not be subject to double taxation, regardless of the amount of salary paid. The corporation would need to pay approximately $120,000 in salary to each shareholder-employee in order to make the maximum possible contribution to the pension plan for each. The salary paid would be subject to the retirement and Medicare portions of the FICA tax, both as withholding from the employees and matched by the employer portion. Any retained amount would not be subject to the 2.9% Medicare tax. After the corporation had paid $120,000 salary to each, it is doubtful that the IRS would treat any additional distributions as disguised compensation.

> If the corporation attempted to set an **unreasonably low level** of compensation, in order to avoid FICA tax, any distributions could be recharacterized by the IRS as disguised compensation and would be subjected to FICA tax, FUTA tax, and all penalties for failure to remit these taxes in a timely manner. [See Revenue Ruling 74-44, 1974-1 CB 287, *Radtke v. U.S.* 90-1 USTC 50,113,(7th Cir.), *Spicer Accounting, Inc., v. U.S.*, 918 F. 2d 90, (9th Cir., 1990), and *Esser v. U.S.*, 750 F.Supp 421 (D. Ariz., 1990), *Boles Trucking, Inc. v. U.S.*, 75 AFTR 95-799 (D. Neb., 1995), *Ziobron Inc. v. U.S.*, 80 AFTR 2d 97-8202.]

HEALTH BENEFITS

SITUATION 13: *Refer to Situation 11. The business is considering paying for health insurance for the two principal owners. The premium would be $3,600 for each.*

- **If the business is a limited liability company, what would be the net effect on taxable income to the business and to Martha and Adrienne?**

■ **Discussion:** The health insurance premiums would be **deductible** to the company, but would be taxable as **guaranteed payments to the two members.** [**Rev. Rul. 91-26, 1991-1 CB 184.**] The premiums would also be taxable as self-employment income. Self-employment income includes each partner's guaranteed payments for services or capital. [**Regulations §1.1402(a)-1(b).**] Each member would be entitled to deduct a portion of the health insurance premium on page 1 of her Form 1040 (45% for 1998 and 1999). [**§162(l).**] Note, however that this deduction would **not reduce** the self-employment income of either member. **The remaining 55% of the premium would be allowed as a medical expense on schedule A.**

- **If the business is a C corporation, what would be the net effect on taxable income to the business and to Martha and Adrienne?**

■ **Discussion:** The premiums would be **deductible** by the corporation as ordinary and necessary business expenses. [**§162.**] The shareholder-employees **are specifically allowed to exclude** these benefits from gross income. [**§106.**] Note that there is no nondiscrimination requirement for the exclusion under **§106.**

- **If the business is an S corporation, what would be the net effect on taxable income to the business and to Martha and Adrienne?**

■ **Discussion:** In this situation the S corporation occupies a middle ground between the two other entities. The shareholder-employees are limited to the tax treatment of partners with respect to certain fringe benefits, **including accident and health insurance premiums.** [**§1372.**] **Thus they are required to report the benefit as gross income.** The proper way to report is for the corporation to include the value of the premiums as **noncash compensation on each shareholder-employee's Form W-2.** [**Rev. Rul. 91-26, 1991-1 CB 184.**] The premiums are specifically permitted to be treated in the same manner as a self-employed person, so the shareholder-employees may claim a page 1 deduction for **45% of the cost.** [**§162(l).**]

The remaining 55% of the premium would be allowed as a medical expense on schedule A.

Thus it appears that each shareholder-employee would be subject to the same treatment as in the situation where they were members of a limited liability company.

There is one important difference, whose impact varies with the level of income and compensation. Although the premiums must be treated as self-employment income to the partners in a partnership, via their categorization as guaranteed payments, they are not treated in the same manner with respect to shareholder-employees in S corporations. The FICA rules specifically exempt employee accident and health insurance premiums from categorization as FICA wages. [**§3121(a).**] The IRS has instructed taxpayers to treat these premiums as **non-FICA compensation.** [Announcement 92-16, 1992-5 IRB.] Therefore, the only disadvantage to the S corporation shareholder-employee compared to the C corporation shareholder-employee is **the loss of 55% of the exclusion.**

BASIS OF OWNER'S INTEREST

SITUATION 14: *Bob and Bill each own 50% of the equity in BB Company. Bob and Bill had each contributed $15,000 as equity capital. Subsequently, BB borrows $100,000 from the local bank. Bob and Bill individually guarantee the loan.*

- **What is the effect of this arrangement on the owners' bases if BB is a limited liability company?**

■ **Discussion:** Each member (partner) would treat his proportionate share of the liability as if it were a **contribution of cash** to the limited liability company. [**§752(a).**] Determination of a member's share of the company's liabilities can be somewhat difficult, except in the most straightforward circumstances. The first step is to distinguish **between recourse and nonrecourse liabilities.** For purposes of the partnership rules a nonrecourse loan is one for which no partner has any personal liability. [**Regulations §1.752-1(a)(2).**] Any loan for which any partner or any person or entity related to the partner has personal liability is treated as a recourse liability. [**Regulations §1.752-1(a)(1).**] **The guarantee by one or more members has the effect of classifying the liability as a recourse liability.**

A partner's relative portion of a partnership recourse liability is that partner's economic risk of loss. [**Regulations §1.752-2(a).**]

In order to determine this risk of loss, the partnership and the partners calculate the effects of a (hypothetical) constructive liquidation, which consists of the following calculations:

1. All properties secured by nonrecourse liabilities are sold for the amount of the liabilities. [**Regulations §1.752-2(b)(2)(i).**] Gain or loss on each of these sales is the difference between the amount of liability on each property and the book value of each property. [**Regulations §1.752-2(b)(2)(i).**]
2. All other properties are sold for zero. The loss on these properties is the book value on the date of constructive liquidation. [**Regulations §1.752-2(b)(2)(ii).**]
3. At this point, the partnership has no assets, and still has all of its recourse liabilities to pay. Accordingly, the obligation of each partner to make payments on partnership liabilities must be examined. The factors considered are:

   - Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership. [**Regulations §1.752-2(b)(3)(i).**]
   - Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership. [**Regulations §1.752-2(b)(3)(ii).**]
   - Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute. [**Regulations §1.752-2(b)(3)(iii).**]

In this case, since Bob and Bill are equal owners, the arrangement is probably that each would need to contribute 50% of a deficit upon a constructive liquidation. Thus Bob and Bill would **each** treat $50,000 of the liability as his own portion, and each would add $50,000 to his basis to reflect his share of economic loss.

- **What is the effect on basis if only Bob guarantees the loan?**

■ **Discussion:** In this case, it appears that Bob would have the **entire risk of loss.** Therefore, the liability would add $100,000 to Bob's basis and would not increase Bill's basis. The parties could change this ratio, however, by having Bill indemnify Bob for a portion of the liability. **For example,** if Bill agreed to pay Bob $40,000 if Bob should be required to perform in his guaranty, Bill would treat $40,000 as his share of liability. Bob would treat his guarantee of $100,000, less the indemnification of $40,000, or a net amount of $60,000, as his share of liabilty. There are serveral other factors that could comlexify this issue. **However, if the liability is a recourse liability the entire amount will add to one or more of the partners' adjusted bases in the partnership.**

- **What is the effect of this arrangement on the owners' bases if BB is an S corporation?**

■ **Discussion:** The guarantee of a corporation's loan **does not immediately add** to any shareholder's basis. This problem has been litigated frequently, with the IRS prevailing in the vast majority of cases. *Raynor***,** 50 TC 762 (1968) was an early case and is still often cited. In that case the court stated that **"***No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay all or a part of the obligation.*" As recently as 1998, the case is still being cited. Recent cases on point include *Spencer***,** 110 T.C. No. 7 (1997), *Sleiman***,** TC Memo 1997-530, and *Salem***,** TC Memo 1998-63. The IRS has ruled that a shareholder can obtain basis for a guaranteed loan when the shareholder actually pays the debt on the corporation's behalf. [**Rev. Rul** 70-50, 1970-1 **CB** 178.] Such payment, however, will not allow a shareholder to claim basis due to hindsight in an earlier year. [**Rev. Rul.** 71-288, 1971-2 **CB** 319.] Moreover, there must have been an actual "economic outlay" by the shareholder. [**Rev. Rul.**

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81-187, 1981-2 **CB** 167.] In other cases, a loan to the S corporation by a related entity under common control has not given basis to shareholders. [See *Prashker*, 59 TC 172 (1972), *Underwood v. Commissioner*, 76-2 USTC 9557 (5th Cir.), *Allen*, TCM 1988-166, *Wilson*, T.C. Memo. 1991-544.]

As of 1998, there is a conflict among the circuits. The only case to date where a shareholder was actually allowed to **claim basis** for a guarantee was *Selfe v. U.S.*, 86-1 USTC 9115 (**11th Cir.**). Other circuits have **not followed** the Selfe case. See *Leavitt*, 89-1 USTC 9332 (**4th Cir.**), *Harris v U.S.*, 90-2 USTC 50,341 (**5th Cir.**), *Goatcher v. U.S.*, 91-2 USTC 50,450, (**10th Cir.**), *Uri v. Commissioner*, 91-2 USTC 50,556, (**10th Cir.**). The Tax Court continues to base its decisions on the opinions of the circuits other than the **11th Circuit.**

The IRS has provided a useful ruling on obtaining basis when shareholders have guaranteed loans. Execution of the shareholder's personal note with the lender in payment of the corporation's debt constitutes performance of the shareholder's guaranty. Under the doctrine of subrogation, the corporation's note to the lender becomes an obligation of the corporation to the shareholder. When that occurs, the shareholder has basis. [**Rev. Rul.** 75-144, 1975-l **CB** 277.] The IRS allowed shareholders to claim basis for such an arrangement, even though the corporation's assets remained pledged as collateral. [**PLR** 8747013.]

REDEMPTION OF OWNER'S INTEREST

SITUATION 15: *ABC Company is owned by Alice and Ben, husband and wife, and their daughter Charlene. The parties would like to buy back Alice's ownership interest.*

- **How will this transaction be treated, at the owner level, if ABC is a partnership or limited liability company?**

■ **Discussion:** **Alice will be able to recover her basis.** If the payment exceeds that amount, she may also report **capital gain, ordinary income or both.** Payments in elimination of a partner's interest in a partnership are subject to dual classification. **First,** the partnership must determine what amount is in exchange for the partner's interest in the fair market value of partnership property. Then it must determine if there are excess payments over that value.

Section 736(b) treats all payments to the retiree or successor as payment in exchange for partnership property, before any excess is accounted for. If a payment is made to a partner in exchange for his or her interest in partnership property, there are two ramifications:

- The partner receiving the payment **treats this portion of the distribution in the same manner as any other distribution from a partnership. He or she recovers his or her basis and reports any additional payment as gain, if the partner receives cash.** The gain may be characterized by **§751(b)** as ordinary income, to the extent that the partner's share of **hot assets** changes. There are, however, **special rules** for the definition of hot assets which are applicable only in the context of **§736.**

- The partner and the partnership would also need to observe the special rules for distributions **within seven years of a contribution** of the property received by the partner, or within seven years following the contribution of other property by the partner whose interest is being liquidated.

- The partnership which makes the payments **does not deduct the payments.** If the payments made by the partnership are unequal to the partner's basis in partnership property, the partnership may adjust its basis in assets retained, but only if the partnership has a **§754** election in effect for the year.
- Amendments made to **§736** by the Revenue Reconciliation Act of 1993 create divergent definitions of payments in exchange for partnership property.

1. **If capital** (as opposed to services) **is a material income producing factor** of the partnership, and the retiree is a general partner (or the deceased partner was a general partner), **partnership property does not include unrealized receivables** (defined by rules only applicable to **§736**).

   In this situation, partnership property does not include the retiree's share of partnership goodwill, unless the partnership agreement specifically treats goodwill as partnership property.

   However, the partnership agreement may specify that goodwill is partnership property. Under such an agreement, payments to the retiree for his or her share of goodwill are treated as payments in exchange for property. Any payment to a partner in exchange for his or her unrealized receivables are treated as **§736(a)** payments, **discussed below.**

2. If the retiree is not a general partner, or if capital is not a material income producing factor, payments in exchange for the retiree's interest in partnership property include unrealized receivables and goodwill (regardless of the treatment of goodwill specified in the partnership agreement).

When the total of payments to be received under the agreement exceed the partner's interest in partnership property, they are treated as **ordinary income** to the recipient. Their treatment at the partnership level depends on the nature of the arrangement.

1. If the payments are determined without regard to the partnership's income during the period of the arrangement, **they are treated as guaranteed payments.** A guaranteed payment is treated as an **ordinary income** to the partner and an ordinary deduction to the partnership.
2. If the payments are determined as a percentage of partnership income, they are treated as **distributive shares to the retiree.** They thus reduce the percentage of partnership income to the continuing partners.

- **How will this transaction be treated, at the owner level, if ABC is a C corpora tion?**

■ **Discussion:** Alice might report a dividend, for the entire proceeds, or as a sale of her stock to the corporation, resulting in a capital gain, depending on the classification of this transaction, **which is a stock redemption.** A "stock redemption" is simply a purchase by the corporation of its own stock from its shareholders. From the shareholder's view, a redemption of his or her stock **is simply a sale of the corporation's own stock back to the corporation.** When the shareholder desires to dispose of part or all of his interest in the business, the redemption may be useful as a financing technique.

Section 317(b) indicates that a redemption has occurred where the corporation acquires its stock from a shareholder in exchange for property. There is no need for the stock to be canceled or retired. **While a redemption appears to be simply a sale, it in fact may be a disguised dividend.** Consequently, before sale treatment is granted, the redemption portion of the transaction must pass the tests of **§302. Failure of these tests normally condemns the transaction to dividend treatment.** The tests are contained in **§§302** and **303.**

1. Not essentially equivalent to a dividend [**§302(b)(1)**].
2. Substantially disproportionate (non pro rata) [**§302(b)(2)**].
3. Complete termination of the shareholder's interest in the corporation [**§302(b)(3)**].
4. Redemption from noncorporate shareholder in distribution qualifying as a partial liquidation [**§302(b)(4)**].
5. Redemption to pay death taxes. [**§303**].

If the distribution does not meet one of the above tests, it does not qualify as a redemption distribution. In such case, the distribution is subject to the normal distribution rules contained in **§301** and therefore is treated as a **dividend** to the extent it is out of E&P [**§302(d)**].

It is unlikely that the redemption in this case would qualify under **§302(b)(1),** which is a backstop provision that is occasionally used. Similarly, there is no evidence that the transaction is the result of a partial liquidation, which might qualify as an exchange under **§302(b)(4).** The redemption to pay death taxes, **§303,** likewise appears to be inapplicable. **This leaves the substantially disproportionate redemption or the complete termination of a shareholder's interest.**

To qualify as a substantially disproportionate redemption the shareholder whose stock has been redeemed must own less than 50% of the outstanding shares in the corporation after the redemption. Furthermore he or she must own less than 80% of the relative voting power and less than 80% of the relative percentage of shares that he or she owned before the redemption. **Since Alice owns no shares after the redemption, she appears to meet these tests.** However, the ownership counted for these tests includes constructive ownership, by the rules of **§318.** Those rules include spouses and children as related parties from whom ownership is attributed. **[§318(a)(1).]** Therefore, **Alice will be treated** as the owner of 100% of the stock after the redemp-

The **only test remaining is the complete termination of a shareholder's interest.** [**§302(b)(3).**] If certain requirements are satisfied, termination of the shareholder's interest can be determined **without application of the family attribution rules–**and only the *family* attribution rules. This enables redemptions in closely held corporations to qualify that otherwise would not. **Three tests must be met to qualify for waiver of the family attribution rules** [**§302(c)(2)**].

1. Immediately after the redemption the shareholder **must not have any type of interest in the corporation** other than that of a creditor. The so-called "prohibited interest" rule expressly prohibits interests as a shareholder, employee, director, or officer.
2. The redeemed shareholder must continue his good behavior to ensure sale treatment. He cannot acquire any of the prohibited interests **for 10 years** after the redemption including an interest in a subsidiary, parent, or successor.

3. The shareholder must sign the so-called "triple i" agreement contained in **§302(c)(2)(iii)** promising that he will notify the IRS if he is not good, i.e., he acquires a forbidden interest. However, these rules are not violated if the shareholder acquires an interest by bequest or inheritance.

The redeemed shareholder must be careful not to acquire any type of interest either directly or indirectly through services rendered to the corporation. **Generally the IRS has taken the position that the performance of services for the corporation by the redeeming shareholder will be considered an acquisition of a prohibited interest.** This conclusion derives from the presumption that the ex-shareholder's continued service is evidence that he never intended to completely sever his interest from the corporation and thus the redemption was merely a means to bail out E&P at capital gains rates. The most recent decisions in this area suggest that no services may be formed for the redeeming corporation. See *Seda*, 82 TC 484, *Perry S. Lewis*, 47 TC 129, *Estate of Lennard*, 61 TC 554, *William M. Lynch*, 86-2 USTC 9731 (CA-9)].

If Alice complies with all of these requirements, she will be able to treat the **redemption as an exchange.** By doing so, she would subtract her adjusted basis in the shares from the redemption proceeds to determine her **gain or loss realized.** If there is a gain, **it is most likely a capital gain.**

Moreover, if she receives an installment note from the corporation she could report the gain by the installment method of accounting. [**§453.**]

If she realizes a **loss,** she will not be able to claim a deduction, since she would have sold her stock to a related party, within the meaning of **§267(b).** Therefore, the loss **would be disallowed** under **§267(a)(1),** which does not waive family attribution.

If the redemption did not meet the exchange criterion, the corporation would treat the proceeds as an ordinary distribution. It would reduce its earnings and profits for the full amount of the redemption. If the redemption proceeds exceeded the corporation's earnings and profits, it would reduce paid in capital. Such excess would not be treated as a dividend to Alice, but would reduce her basis to the extent thereof. Any distribution in excess of both the corporation's accumulated earnings and profits and Alice's basis would be treated as a gain. If the redemption were treated as an exchange, the corporation would reduce its earnings and profits by 1/3 of the balance accumulated as of the date of the redemption. [**§312(n)(7).**]

- **How will this transaction be treated, at the owner level, if ABC is an S corporation with substantial AAA and low AEP?**

■ **Discussion: An S corporation is subject to the same five tests for sale treatment on a redemption.** [**§1371,** PLRs 8739007, 8748034.] **However,** due to the different tax status of an S corporation from a C corporation, the significance of the tests may differ markedly. If the S corporation has no accumulated earnings and profits, or has sufficient AAA to cover the entire redemption distribution, treatment as sale or exchange, as opposed to corporate distribution, has no significant effect on a shareholder whose stock is redeemed. **Any distribution would be treated as a reduction of shareholder basis to the extent thereof, and gain thereafter.** [**§1368(b), §1368(c).**]

Thus Alice would treat the redemption as a reduction in her stock basis thereof, if the redemption did not exceed the corporation's AAA, and did not exceed her basis. Any amount of the distribution that did not exceed the corporation's AAA, but did exceed her basis, would be treated **as a gain.** There would be no difference to Alice as to the characterization as a sale or distribution, so long as the distribution did not exceed the corporation's AAA. If the distribution did exceed the AAA, and was not treated as an exchange, Alice would report dividend income to the extent of the excess of the distribution over the AAA.

If the distribution does not qualify as an exchange, the corporation would reduce its AAA (but not below zero) for the full amount of the distribution. Any amount in excess of the AAA would reduce the corporation's accumulated earnings and profits (but not below zero). If the distribution exceeded both the AAA and the accumulated earnings and profits the corporation would reduce paid-in capital. [**Rev. Rul. 95-14,** 1995-1 CB 169.]

If the distribution does qualify as an exchange, the corporation reduces its AAA for the proportionate percent of shares redeemed, in this case, 1/3. [**Regulations §1.1368-2(d)(1)(ii).**]

- **How will this transaction be treated, at the owner level, if ABC is an S corporation with minimal AAA and high AEP?**

■ **Discussion:** If the S corporation has accumulated earnings and profits and insufficient AAA to cover the distribution, the treatment as a sale or exchange can have important tax consequences. **The shareholder would be likely to exhaust the corporation's AAA, and be treated as receiving a dividend, if the redemption did not qualify as an exchange.** Moreover, the other shareholders would be unable to withdraw any AAA until it had been restored by future earnings.

SITUATION 16: *ABC company, above, wants to use appreciated real estate to buy back Alice's interest.*

- **How will this transaction be treated, at the entity level, if ABC is a partnership or limited liability company?**

■ **Discussion:** The limited liability company would observe the normal noncash property distribution rules. It makes little difference whether or not the member retains any interest in the company after the distribution, except for **§736(a)** payments. This would apply if the fair market value of the real estate exceeded the fair market value of Alice's interest in partnership property. **This excess would be treated as ordinary income** to Alice and as a deduction to **the partnership** in the form of a **guaranteed payment.**

The most common source of complexity when a member withdraws from a limited liability company or other form of partnership is that the member's share of the partnership's unrealized receivable and substantially appreciated inventory items **is reduced.** Accordingly, the partnership and the partner must wade through the tedious and complicated rules of **§751(b)** in order to determine how much of the distribution is treated as a fully taxable sale of the partner's interest in those assets.

There are also the usual complications if the property had been contributed by another partner within seven years preceding the distribution. At the time of the distribution to Alice, the other partner would be **required to recognize gain** as if he or she had **sold** the property to the partnership at the time of the contribution. [**§704(c)(1)(B).**] Similarly, if

Alice had contributed other property to the partnership within seven years preceding the distribution of the real estate to her, she would be required to report gain at the time of the distribution. The amount of gain would be what she would have reported had she sold the contributed property to the partnership for its fair market value at the time of her contribution. [**§737.**]

Absent any of these complications, the distribution of the property to Alice is a simple matter from a tax point of view. **Neither the partnership nor Alice recognizes any gain.** [**§731(a).**] Alice substitutes her basis in her partnership interest to become the basis of the real estate received. [**§732(b).**] The partnership does not make any adjustment to the basis of the assets it retains after the distribution unless it has a **§754** election in effect. If it has such an election in effect, or makes such an election with its Form 1065 for the year of the distribution, it will make an adjustment to basis of assets retained in the partnership. [**§734(b).**] If Alice's basis in her partnership interest, immediately before the distribution, was less than the partnership's predistribution basis in the property, the partnership would increase basis in the assets retained. [**§734(b)(1)(B).**] If Alice's basis in her partnership interest prior to the distribution exceeded the partnership's predistribution basis in the real estate the partnership would reduce basis in its remaining assets. [**§734(b)(2)(B).**]

- **How will this transaction be treated, at the entity level, if ABC is a C corporation?**

■ **Discussion:** The corporation **would recognize gain** on the distribution of the property, as if it had been sold at its **fair market value** to Alice at the time of the distribution. [**§311(b).**] This gain would **increase** the corporation's earnings and profits.

After recording the gain, the corporation and Alice would observe all of the tests discussed in the previous situation. **Thus, Alice must determine if the redemption meets one of the exchange tests, or is treated as a dividend distribution.** In summary, the parties treat the transaction in the exact same manner as if the corporation had sold the property to Alice for cash, and then distributed the cash to Alice.

Alice would report the fair market value of the property as the amount realized in exchange for her ABC shares. Thus the fair market value would be the amount of the distribution, if the transaction did not pass one of the exchange tests in **§302(b).** The fair market value of the property would be the amount realized in exchange for her stock if the redemption **did meet** one of the §302(b) exchange criteria.

[Note: the only test that would seem to qualify this redemption as an exchange is the complete termination of a shareholder's interest under **§302(b)(3).**] Alice's basis in the property received would be its **fair market value.** [**§301(d).**]

- **How will this transaction be treated, at the entity level, if ABC is an S corporation with substantial AAA and low AEP?**

■ **Discussion:**

Again this transaction is treated exactly as if the corporation had **sold the property to Alice for cash,** and then distributed the cash. The gain on the disposition of the property would add to the corporation's AAA, which would then be tested against the value of the property distributed. This gain would be allocated to all shareholders in accordance with their weighted average holdings during the taxable year. [**§1377(a)(1).**]

Since the purchase of Alice's shares would constitute termination of the shareholder's interest, the corporation could elect to close its books as of the end of the day of the distribution. [**§1377(a)(2).**] That day would be Alice's final day as a shareholder. The corporation would allocate 1/3 of its income, deductions, losses, and any other tax items (including the gain on the distribution) up through that day to Alice. **This election would require the consent of all shareholders.** [**§1.1377-1(b)(2).**]

Regardless of any election, Alice and the other shareholders would include their portions of the gain on their tax returns. Alice would also adjust her stock basis, at the time of the redemption, to reflect her portion of the corporation's income, losses, deductions and other items, including the gain on the disposition of the property. [**§1367(a).**]

The AAA **would then be reduced** (but not below zero) for the fair market value of the property distributed. Any excess of the fair market value over the AAA would **reduce** accumulated earnings and profits, but not below zero. Any excess of fair market value over accumulated earnings and profits would reduce paid-in capital. Alice's basis in the property received would be its fair market value. [**§301(d).**]

- **How will this transaction be treated, at the entity level, if ABC is an S corporation with minimal AAA and high AEP?**

■ **Discussion: The effect would be exactly the same as above,** except that the distribution is **more likely to create dividend income, due to the relatively low AAA balance.** However, the gain on the disposition of the real estate to Alice would add to the AAA, immediately before the reduction to that account for the fair market value of the distribution.

LIQUIDATION OF BUSINESS

SITUATION 17: *Ellco has four owners, all of whom are individuals. The business has sold substantially all of its operating assets. It now has an installment receivable. It expects that its income for the foreseeable future will largely be from passive investment sources.*

- **What would be the tax consequences of Ellco remaining in existence if it is a limited liability company?**

■ **Discussion:** If the limited liability company remained in existence, it would merely **allocate out** the interest income, and any deferred gain, each time it collected an installment. [**§703.**] This income would retain its character to each member, who would report it on his or her Form 1040. [**§702.**] Under normal circumstances each collection of the installment receivable would give the company cash to distribute to its members in accordance with the operating agreement. Each collection of interest and principal on the installment note would give the members basis to cause the cash distribution to be completely or **mostly nontaxable.** [**§705, 731(a).**]

- **What would be the tax consequences of Ellco remaining in existence if it is a C corporation?**

■ **Discussion: This situation is almost certain to result in personal holding company problems.** The corporation meets the ownership test of a personal holding company. The interest it collects on the note receivable would probably comprise 100% of its ordinary gross income, since the gains being reported by the installment method would most likely be capital or **§1231** in nature.

Thus as long as the corporation remains in existence, it will need to pay the regular corporate income tax on the installment gain, plus the interest income. In addition, **it will need to distribute out its income as dividends** to the shareholders, **or** it will pay the personal holding company tax of 39.6% on each year's accumulation.

The corporation might be able to lessen the double tax burden by paying its shareholders compensation. **This result is not a very safe alternative, however, since the shareholders are probably performing little or no services for a corporation whose only asset is an installment receivable.** Perhaps for a year or two it could justify deductible compensation to shareholders based on their under-compensation in past years. [For an example of this strategy, see *White's Ferry, Inc.*, TC Memo 1993-639, 66 TCM 1855. However, this strategy would have its limits as years elapsed since the corporation last had an active business operation.]

- **What would be the tax consequences of Ellco remaining in existence if it is an S corporation with no AEP?**

■ **Discussion:** If the S corporation has no accumulated earnings and profits it may continue to collect installments and interest, report the gain and income to the shareholders and make distributions to these shareholders indefinitely. There is **no problem** with passive investment income. **An S corporation is exempt from both the regular corporate income tax and the personal holding company tax.** [**§1363(a).**]

- **What would be the tax consequences of Ellco remaining in existence if it is an S corporation with substantial AEP?**

■ **Discussion:** Even if it has passive investment income, an S corporation is exempt from both the regular corporate income tax and the personal holding company tax. [**§1363(a).**]

Therefore, at first glance, it would appear that the S corporation can continue in existence and collect the interest and principal on the installment receivable forever, in the same manner as if it were a partnership or limited liability company. [See discussion above.]

The presence of accumulated earnings and profits, however, can create two serious problems if the corporation has substantial passive investment income.

If a corporation has accumulated earnings and profits at the end of any year, and has gross receipts from **passive sources in excess of 25% of its total gross receipts,** it will be subject to the tax on "excess net passive income." [**§1375.**] If the corporation has accumulated earnings and profits, and has gross receipts from passive sources in excess of 25% of its total gross receipts, **for three consecutive years,** its election will be terminated as of the **fourth year.**

The term "passive income," when used in Subchapter S, has no relationship to the term as used in §469, limiting losses from passive activities. It includes some, but not all, elements of "passive income," as well as some elements of "portfolio income." In this case the interest on the installment receivable would definitely be passive investment income, and is likely to subject the corporation to these problems. Moreover, after the corporation loses its S election it is likely to become a personal holding company, subject to the problems discussed under the C corporation scenario, above.

An S corporation may cure itself from exposure to passive investment income problems **by ridding itself of its accumulated earnings and profits.** It may do so by over-distributing the AAA, or by making an election to bypass the AAA in favor of its AEP. [**§1368(e)(3).**] If the S corporation does not have sufficient distributions in a taxable year to exhaust its accumulated earnings and profits the corporation and its shareholders may make a deemed dividend election and treat the shareholders as if they had received dividends for the corporation's entire balance of accumulated earnings and profits at the close of the taxable year. [**§1.1368-1(f)(3).**] However, in this instance, the presence of a large amount of accumulated earnings and profits may make the taxable dividend prohibitively expensive to the shareholders.

- **What would be the tax consequences of Ellco remaining in existence if it is an S corporation with low AEP?**

■ **Discussion:** The corporation would be subject to **both** the passive investment income tax and termination as in the above discussion, even if its accumulated earnings and profits were very low. Therefore, it should make the proper elections to distribute this balance out to the shareholders if it does not intend to liquidate.

- **What would be the tax consequences of Ellco liquidating if it is a limited liability company?**

■ **Discussion:** When it liquidates, the company will distribute out all of its assets to its partners. At first glance, it appears that there may be some exposure for recognition of gain on the disposition of the installment receivable. **Section 453B** provides that any taxpayer who disposes of an installment receivable is deemed to have **sold** it at its fair market value and must report all the deferred gain.

However, this rule **does not apply** to certain nonrecognition transactions specified in **§453B.** A distribution by a partnership to a partner is **not directly specified,** so the statute **may not clearly exempt** the transaction from acceleration of the gain. However, **§453B** does not override the nontaxablity rule of **§731,** which treats property distributions from partnerships as nontaxable events. **The IRS has held in regulations that there is no gain on the disposition of an installment receivable when it is distributed by a partnership to a partner.** [**Regulations §1.453-9(c)(2).** Also see PLR 9620020.]

Therefore, this distribution to the partners would be the same as any other property distribution. By the time the sole asset has been reduced to an installment receivable, there are probably no unrealized receivables or substantially appreciated inventory items. Even though an installment receivable might appear to be an unrealized receivable, it is typically not classified as such, if it produces capital gain or **§1231** gain. [**§751(c).**] **Therefore, it is unlikely that the distribution would have an effect on any partner's relative portion of these assets, so no part of the distribution would be treated as a taxable sale.** There is always the caution to be observed that if a partner had recently contributed property to the partnership that there would be a gain recognized to that particular partner. It is possible that the distribution would be treated a consideration received in a disguised sale, or it would subject the partner to gain recognition under §737.

- **What would be the tax consequences of Ellco liquidating if it is a C corporation?**

■ **Discussion:** The disposition of the installment receivable **would trigger immediate recognition of the gain** to the corporation. [**§453B.**] It would include this gain on its final Form 1120.

The shareholders would recognize gain on the receipt of the property in liquidation. They would treat the fair market value of the property received as the amount realized in exchange for their stock. [**§331(a).**] There would be **no dividend income,** and the corporation's earnings and profits would be completely eliminated as a result of the liquidating distribution. [**§331(b).**] The shareholders take a basis of fair market value at the time of the distribution for most property received. [**§334(a).**]

However, there is some relief to the shareholders when the corporation distributes an installment receivable in complete liquidation. In general, a shareholder who receives an installment obligation from a corporation in complete liquidation must generally take the obligation into account at its fair market value.

However, if the installment receivable was generated in a liquidating sale of assets by the corporation, the shareholder treats the receivable as if it were received for an installment sale of stock. [**§453(h)(1).**] The shareholder must allocate his or her stock basis between the installment receivable and any other property received from the corporation in proportion to the relative fair market values. The shareholder will then report the gain attributable to any other property when received. The shareholder will recover the remainder of his or her basis and report gain under the installment method, as the payor makes payments.

- **What would be the tax consequences of Ellco liquidating if it is an S corporation?**

■ **Discussion:** In general, the liquidation under these circumstances would be the same as that of the partnership or limited liability company. The S corporation **does not recognize gain on the distribution of the installment receivable,** if the receivable were generated in a liquidating sale of the corporation's assets. [**§453B(h).**] the shareholders would be in the same position as those of the C corporation, and would report any gain on the disposition of their shares by the installment method, as the payor makes the installment payments. [**§453(h).**]

The presence or absence of accumulated earnings and profits would have no effect on this analysis, since earnings and profits are completely eliminated in a corporate liquidation. [**§331(b).**] Any property other than an installment receivable would be taken into account at its fair market value, and would give basis to the shareholders of the same amount. [**§331(a), §334(a).**]

The corporate relief provision of §453B(h) does not apply to an S corporation's built-in gain tax liability. Therefore, If any of the as yet unreported gain in the installment receivable would be a recognized built-in gain, the corporation would need to pay the built-in gains tax on that portion. It would need to pay this tax for its final taxable year, which would include the liquidating distribution to the shareholders.

INHERITANCE OF BUSINESS

SITUATION 18: *Several years ago George placed his farm land into a family business. George retained a 90% interest in the business. His son Bob and daughter Carrie each owned 5%. Recently George died. Bob and Carrie each inherited half of his property, so they own 50% each after his death. When George contributed the farm land it had a basis of $100,000. He gave a 5% interest in the property to each of his two children immediately before the contribution to the business. The transfer to the business was a nontaxable exchange. At the time of George's death the property had a value of $1,100,000. Thus the fair market value of George's 90% interest in the property was $990,000. Bob and Carrie are considering selling the property, so they are interested in its basis.*

- **What are the basis implications if the family business is a limited partnership or limited liability company?**

■ **Discussion:** If the company does not have a §754 election in effect, the basis of the land **will remain at $100,000** following George's death. However, if the company makes a §754 election, the basis of the 90% inherited by Bob and Carrie **is stepped up** to its fair market value at the date of George's death (or alternate valuation date, if elected for the estate). Thus the basis would be:

Outside basis of interests held by children	
Portion always held by Bob or Carrie (5% of $100,000)	$ 5,000
Portion attributable to George's interest (50% of $990,000)	495,000
Total basis after George's death	$ 500,000
Inside basis of assets held by company	
Portion always held by Bob and Carrie (10% of $100,000)	$ 10,000
Portion attributable to George's interest (90% of $1,100,000)	990,000
Total basis after §743(b) adjustment	$ 1,000,000

If they were to sell the property at its fair market value of $1,100,000, they would **only recognize $100,000** total gain between them. It would make no difference whether the company sold the property directly to the buyer, or if it distributed out 50% to each member, who then sold his or her interest.

- **What are the basis implications if the family business is a C corporation?**

■ **Discussion:** This is perhaps the most **serious disadvantage** of a C corporation. Each of the children would received a **basis stepped up** to fair market value in the **stock** they inherited. Thus the basis to each would be the same, regardless of the business form.

Outside basis of interests held by children	
Portion always held by Bob or Carrie (5% of $100,000)	$ 5,000
Portion attributable to George's interest (50% of $990,000)	495,000
Total basis after George's death	$ 500,000

However, there is no means to step up the basis of property held inside a corporation after a transfer of its stock. Therefore, the basis of the land to the corporation would remain at $100,000.

If the corporation were to sell the land, it would recognize a gain of $1,000,000, resulting in a corporate level tax of $340,000. It would then be faced with the possibility of liquidating or remaining in existence as a personal holding company. If it liquidated, the consequences would be:

Amount realized from sale of land	$ 1,100,000
Less corporate income tax (34% of gain of $1,000,000)	(340,000)
Net assets after tax	$ 760,000

At this point, the double taxation rules add insult to injury. Each shareholder would receive half of the corporation's assets, and would report the following:

Amount realized from corporation	$ 380,000
Less adjusted basis in stock	(500,000)
Capital loss	$ 120,000

Unless a shareholder had substantial capital gains to offset this loss, it would take 40 years to use the loss against ordinary income. Note that there is no way to offset the corporation's gain with the shareholders' losses.

Also note that the results would be exactly the same if the corporation had liquidated and distributed the land to the children. It would recognize gain as if the land had been sold at its fair market value. [§336.] If the corporation distributed the land to the children, they would need to come up with $340,000 of cash to put back into the corporation in order to enable it to pay its income tax. They would get no tax benefit for this contribution, except to increase basis in stock of a corporation that they are immediately liquidating.

- **What are the basis implications if the family business is a C corporation, but the children immediately elect S status?**

■ **Discussion: The corporation would be subject to the built-in gains tax of §1374 for a period of ten years following its S election.** This tax is imposed at the flat rate of **35%.** [§1374(b)(1), §11(b).] Therefore, the corporation would report the following:

Amount realized from sale of land	$ 1,100,000
Less corporate income tax (35% of gain of $1,000,000)	(350,000)
Net assets after tax	$ 750,000

The net after tax gain of $650,000 would pass through to the two children at $325,000 per person. [§1366(f)(2).] Thus the net amount would add to the basis of each shareholder. [§1367(a)(1)(A).]

Basis of stock before gain	$ 500,000
Add gain from corporate sale	325,000
Net basis after pass through of gain	$ 825,000

If the corporation then liquidated, the shareholders would each report the receipt of the property in the liquidating distribution as

Amount realized from distribution of cash	$ 375,000
Less basis in stock	(825,000)
Net capital loss	$ (450,000)

Assuming that each child could treat a §1231 gain as a capital gain, the results would be:

Offset of gains and losses	
Gain from corporate sale	$ 325,000
Net capital loss from liquidation	(450,000)
Net capital loss after offset	$ 125,000)

Note that this situation offers a disadvantage over remaining a C corporation. The reason is that the built-in gain tax on the corporation is imposed at a higher rate than the C corporation tax at this level of income.

The S election in this situation might have **one advantage** over remaining a C corporation. An S corporation's income, even a built-in gain, does not add to the corporation's earnings and profits. Thus if the corporation had no earnings and profits it could remain in existence and collect passive investment income. However, the children's stock bases would remain high, with no apparent tax benefit in sight. **Even the minimal $3,000 annual offset against ordinary income might be a better tax benefit than merely leaving the corporation in existence.**

It would be better from a tax point of view if the corporation held the land for at least ten years following the effective date of its S election. It would then receive the results shown below. If this is impossible, the corporation might want to exchange the land for other property in a transaction that qualifies as a like-kind exchange under §1031. The exchange would not result in any immediate income tax to the corporation or to its shareholders. The corporation would need to retain the replacement property until ten years had elapsed from its S election, or the sale of the replacement property would result in the same built-in gains tax liability as the sale of the original property. **[§1374(d)(6).]**

- **What are the basis implications if the family business is an S corporation, and has held that status for at least ten years?**

■ **Discussion:** The results would be nearly as good as those of a partnership in this fact pattern. The corporation **would not receive a step-up in basis,** so the sale of the land would result in $1,000,000 of §1231 gain. 50% of that amount would pass through to each shareholder. Each shareholder would then adjust basis in stock as follows:

Basis of stock before gain	$ 500,000
Add gain from corporate sale	500,000
Net basis after pass through of gain	$ 1,000,000

If the corporation then liquidated, the shareholders would each report the receipt of the property in the liquidating distribution as:

Amount realized from distribution of cash	$ 550,000
Less basis in stock	(1,000,000)
Net capital loss	$ (450,000)

Assuming that each child could treat a §1231 gain as a capital gain, the results would be:

Offset of gains and losses

Gain from corporate sale	$ 500,000
Net capital loss from liquidation	(450,000)
Net capital gain after offset	$ 50,000