Chapter 5: Transferring a Sole Proprietorship to an LLC

5

Please note. Corrections were made to this workbook through January of 2022. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Georgine Kryda, Ph.D., Esq., LLM (Taxation), is an attorney with over a decade of experience in the areas of trust and estate planning and administration, probate litigation, and tax matters. She is also a CPA, a CFE, a mediator-arbitrator, and based in Golden, Colorado.

Other chapter contributors and reviewers are listed at the front of this volume.

This chapter is devoted to sole proprietors that wish to form a single-member limited liability company (SMLLC) to conduct their business activity. Once the SMLLC is established, its owner may decide to accept the default classification and for the SMLLC to be considered a disregarded entity. They can also consider other organizational options, such as joining with another sole proprietorship or SMLLC to form a partnership, or electing to be treated as an S or C corporation. The chapter also considers dissolution of the SMLLC, occurring by sale, gift, inheritance, or bankruptcy.

Practitioner Planning Tip

Although a tax practitioner should be familiar with the concepts described, the actual changes to a client's organization must be conducted in consultation with an attorney. A team approach is crucial to the success of the process. The word transfer should generate numerous questions in the tax return preparer's mind. The chapter appendix contains a general framework for gathering and organizing client information about transfers.

SOLE PROPRIETORSHIP TRANSFER OPTIONS

A sole proprietorship is usually the default classification under state law for an individual pursuing a business without incorporating. A sole proprietor may be able register a fictitious name with the Secretary of State in their state to do business as (DBA) a name other than that of the sole proprietor.[1]

Example 1. Brandi has a solely owned business that repairs computers and its components. She installs and troubleshoots hardware at the customers' business sites. She also provides remote assistance with software upgrades and security protocols. Brandi has been dabbling in coding new security software that she hopes to bring to market within the year.

Her annual gross income is $80,000. She wants to consider another form of organization to provide legal protection and have an official company name. It is not necessary for Brandi to establish another form of organization to secure her "official" (fictitious) company name. She merely contacts the Secretary of State in the state where she does business and registers her fictitious company name as Brandi, DBA (her fictitious name). However, while this action reserves the **name** for Brandi's use, it does not provide any legal protection for the operation of her business.

For tax purposes though, "[w]hether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law."[2]

A sole proprietorship uses assets directly owned by the sole proprietor. By not incorporating, the sole proprietor personally assumes liability for all business activity.

1. *Sole Proprietorships.* Jun. 11, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/sole-proprietorships] Accessed on Jul. 8, 2021.

2. Treas. Reg. §301.7701-1(a)(1).

Sole proprietors earn gross income under IRC §61. They may take adjustments to gross income associated with the following types of income-producing activities under IRC §62(a)(1).

- **Trade or business — IRC §162(a):** "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."
- **Investment activities — IRC §212:** "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income."
- **Activities not engaged in trade or business — IRC §183:** "activities not engaged in for profit," but only up to the amount of gross income received from the activity.

A sole proprietor who repeatedly fails to realize a profit may be deemed as pursuing an activity not engaged in for profit (i.e., a hobby) and eventually be unable to deduct expenses.[3] Alternatively, the sole proprietor who does not start out seeking profit but is profitable in three out of five years is presumed to be operating for profit under §183(d).

Note. For a detailed discussion of activities engaged in for profit versus hobby activities, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

Sole proprietors report their business activity on Form 1040, *U.S. Individual Income Tax Return,* Schedule C, *Profit or Loss for Business (Sole Proprietorship)*, or on Schedule F, *Profit or Loss from Farming,* using one schedule per activity. The net profits and losses are combined and reported as follows on the Form 1040 and associated schedules.

- Initially on line 3 (or 6) of part 1 of Schedule 1, *Additional Income and Adjustments to Income* (2020)
- Line 9 of part 1 of Schedule 1 is then carried to line 8 of Form 1040 (2020)

PLACING PERSONAL ASSETS INTO A NEW SOLE PROPRIETORSHIP

Because a sole proprietorship is not a separate business entity from the taxpayer, there is **no separate asset transfer** of personal assets from the individual to the proprietorship. Therefore, there is no associated federal income tax effect from transferring appreciated assets from personal use to business use by a sole proprietor.

When assets or funds owned by the sole proprietor are used partially for business and partially for personal purposes, the general rule is to allocate between the amount used for business and personal purposes.[4] Significant substantiation is necessary to properly separate business from personal use of funds or other assets. For example, the home office deduction under IRC §280A requires the business expense associated with the business portion of the dwelling unit to meet **both** of the following requirements.

1. The space is the principal place of business for the trade or business.
2. The space is used exclusively for that trade or business.[5]

The **basis** in the property that was first acquired for personal use and then used for the business, or for the production of income, is the lesser of the following.

- The taxpayer's adjusted basis
- The property's fair market value (FMV) when it is converted for use in a trade or business or for the production of income[6]

---

3. IRC §183(a).

4. See e.g., IRC §280A(c)(4)(C) for the allocation formula when the taxpayer's home is used both as a home office and for personal uses. Remember that IRC §67(g), miscellaneous itemized deductions, are suspended through 2025 under the *Tax Cuts and Jobs Act*, PL 115-97, which became law on Dec. 22, 2017.

5. IRC §280A(c)(1); Rfev. Proc. 2013-13, 2013-6 IRB 478 provides a simplified procedure for calculating the home office deduction.

6. Treas. Reg. §1.167(g)-1.

IRC §167 allows for the **depreciation** of assets used in a trade or business, or for the production of income. IRC §179 allows for expensing of certain depreciable business assets, but only if those assets were **purchased "for use in the active conduct of a trade or business."**[7]

Practitioner Planning Tip

Practitioners should ask when and how assets were acquired when a client wishes to treat the cost or basis of assets as deductible business expenses. If the client previously owned assets before they were placed into service in their trade or business, they are not eligible for the §179 expense election.

Example 2. Joe is quite handy. Over many years, he acquired numerous tools that he used for remodeling projects around his house. Impressed by his work, Joe's friends encourage him to go into the remodeling business. Joe agrees and begins his business enterprise. He does not feel he needs to make a large investment into equipment because he acquired all the needed tools over the years. His conversion of the personal-use tools to the active conduct of trade or business makes the tools eligible for depreciation deductions, but **not the §179 expense election.** An interesting contrast to this rule is that if personal-use assets are converted to business use after September 28, 2017, they are eligible for bonus depreciation.[8]

IRC §197 provides for **amortization** of goodwill and other intangibles held in connection with the conduct of a trade or business or an activity described in §212. It is important to note that **§197(c)(2) excludes intangibles "created by the taxpayer."** However, the special rules under §197(f) provide for recognizing gain when a contract, payment, or other exchange of value exists for an intangible that was self-created by the taxpayer.

Intangibles under §197 include the following.

- Goodwill
- Going concern value
- Workforce in place
- Business books and records — including lists of current and of potential customers
- Patents, copyrights, processes
- Benefits derived from customers such as the customer's market share and contracts to provide future goods or services to the customer
- Benefits derived from suppliers of goods or services used by the business
- Licenses, permits, and other rights granted by a governmental unit
- Covenant not to compete
- Franchise, trademark, or trade name

7. IRC §179(d)(1)(C); Rev. Rul. 77-448, 1977-2 CB 78.

8. IRC §168(k)(2) as temporarily amended by *Tax Cuts and Jobs Act,* PL 115-97, §13201. The changes made by TCJA are scheduled to sunset on Dec. 31, 2025.

Example 3. Kevin Brauer, an enrolled agent, has operated a tax preparation firm for the past 30 years as a sole proprietor. Eager to spend less time preparing tax returns and more time playing golf, he begins the process of positioning his practice for an eventual sale. He meets with a business broker who requests a report of his annual gross income for the past several years. That report reflects an average gross revenue of $250,000 per year and, in the broker's mind, establishes the potential selling price for Kevin's practice. Kevin is quite pleased with the appraisal as he states that he started the business with no more than a calculator and a dream. The broker explains that when Kevin does sell the practice, the value will be in the goodwill he has created over the years and that is what he will be selling.

If Kevin sells his practice for $250,000, the sale will likely be characterized primarily as a sale of self-created goodwill.

TRANSFERRING ASSETS TO AN SMLLC

A sole proprietor who forms a limited liability company (LLC) to conduct business for tax purposes by default is treated as a disregarded entity. A **disregarded entity** (i.e., SMLLC) is defined as "a business entity that has a single owner and is not a corporation."[9]

A conversion from a sole proprietorship to an SMLLC has no effect on the business as it will remain a disregarded entity for IRS purposes. The taxpayer continues to file as, and is subject to, the rules and regulations consistent with sole proprietorship treatment.

Example 4. Use the same facts as **Example 3.** After a particularly nasty exchange with a client who threatened to sue Kevin over a position he took on the client's return, Kevin worries that a lawsuit could cost him all his personal possessions. He meets with a local attorney who suggests Kevin creates an LLC for potential liability protection purposes. Kevin would then transfer his business operations into the newly formed SMLLC. Kevin expresses his desire to keep his bookkeeping and tax filings simple, so he accepts the default treatment of an SMLLC, which is a disregarded entity. Kevin accepts his attorney's advice, and the attorney files the necessary paperwork to establish an LLC.

Certain organizations with a single owner can choose to be recognized or disregarded as entities separate from their owners.[10] The choice to be recognized as a corporation is made on Form 8832, *Entity Classification Election* (discussed later).

Capital Contribution

When a transfer is made by a capital contribution, there are no tax consequences because the SMLLC is a disregarded entity. The transfer gives the transferor 100% ownership as the sole SMLLC member.

Note. The same person cannot sell assets to themselves.

The SMLLC takes the sole proprietor's adjusted basis in each asset.[11] If the sole proprietor previously completely depreciated the item, then the SMLLC's basis is zero.

9. Treas. Reg. §301.7701-3(b)(1).

10. Treas. Reg. §301.7701-1(a)(4).

11. IRC §1011.

Practitioner Planning Tip

It is prudent for a practitioner to advise a taxpayer to acquire a new employer identification number (EIN) for the SMLLC, establish a separate bank account, and other evidence that the SMLLC is being operated as a trade or business.[12]

Domestic Corporation

A disregarded entity is treated as a corporation under IRC §6038A if, at any time during the tax year, the entity is a domestic entity and a foreign person has direct or indirect sole ownership of the entity.[13] Indirect sole ownership may be through other disregarded entities or by one or more grantor trusts.[14] IRC §6038A(a) requires information reporting to the IRS if a domestic corporation is at least 25% foreign-owned.

Check the Box Rules

After creating an LLC in the state where the business is domiciled, it is easy to change how the LLC is taxed. Referred to as the check the box rules, an LLC managing member files Form 8832 with the IRS and indicates the LLC wishes to be treated as a corporation for tax purposes.[15] Although the ease of the initial election process is useful, it is not as easy to revert from a corporate election to a disregarded entity. Once treatment as a corporate entity is elected, reverting to a disregarded entity receives the same treatment as a corporate dissolution (referred to as a deemed liquidation)[16] and may result in significant tax consequences to the LLC member. A flowchart of the process of LLC entity election and the consequences or reverting back are included in the appendix of this chapter.

12. Treas. Reg. §301.6109-1(d)(4)(ii) addresses the EIN; Treas. Reg. §1.183-2(b) discusses nine factors in determining whether an activity is carried on for profit.

13. Treas. Reg. §301.7701-2(c)(2)(vi)(A).

14. Treas. Reg. §301.7701-2(c)(2)(vi)(B).

15. Treas. Reg. §301.7701-3(c)(1).

16. IRC §331(a).

Form **8832**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

▶ **Information about Form 8832 and its instructions is at *www.irs.gov/form8832*.**

OMB No. 1545-1516

Type or Print	Name of eligible entity making election	**Employer identification number**
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	

▶ Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

Part I **Election Information**

1 **Type of election** (see instructions):

a ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

a Name of owner ▶ ____________
b Identifying number of owner ▶ ____________

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

a Name of parent corporation ▶ ____________
b Employer identification number ▶ ____________

For Paperwork Reduction Act Notice, see instructions. Cat. No. 22598R Form **8832** (Rev. 12-2013)

5

Form 8832 (Rev. 12-2013) Page 2

Part I **Election Information** (Continued)

6 **Type of entity** (see instructions):

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
b ☐ A domestic eligible entity electing to be classified as a partnership.
c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
e ☐ A foreign eligible entity electing to be classified as a partnership.
f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶ ____________

8 Election is to be effective beginning (month, day, year) (see instructions) . . . . ▶ ____________

9 Name and title of contact person whom the IRS may call for more information

10 Contact person's telephone number

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

Signature(s)	Date	Title

Form **8832** (Rev. 12-2013)

Part II Late Election Relief

11 Provide the explanation as to why the entity classification election was not filed on time (see instructions).

Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I (we) further declare that I (we) have personal knowledge of the facts and circumstances related to the election. I (we) further declare that the elements required for relief in Section 4.01 of Revenue Procedure 2009-41 have been satisfied.

Signature(s)	Date	Title

Form 8832 (Rev. 12-2013)

5

TRANSFER TO A PARTNERSHIP/MULTIMEMBER LLC (MMLLC)

Just as an SMLLC is by default taxed as a sole proprietorship, the default tax treatment of an MMLLC is under partnership rules.[17] Therefore, the discussion of transferring to a partnership uses the terms partnership and MMLLCs interchangeably.

Qualifying Joint Ventures (QJV)[18]

Rather than create a partnership, some married couples operate as a QJV. Married persons engaged in a QJV under IRC §761(f) are not treated as partners in a partnership if **all** the following situations exist.

- The spouses are the only two owners of the joint venture.
- Both spouses materially participate, as defined under IRC §469(h), disregarding paragraph 5.
- Both spouses elect QJV treatment on their jointly filed Form 1040.
- The couple has not established an LLC for the conduct of their activity.

> **Note.** Spouses who treat a sole proprietorship activity as a QJV may not choose QJV if they formed an LLC.[19] If they formed an MMLLC, they are required to file a partnership return.

Each spouse files a Form 1040, Schedule C, or Schedule F to report the spouse's respective share of income, gain, loss, and deductions.

For spouses who are the sole owners of a QJV as community property,[20] the IRS follows the married couple's tax treatment of the venture as either a disregarded entity or as a partnership.[21]

> **Note.** For more information on QJVs and filing in a community property state, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Schedule C.

> **Note.** The ways in which an entity conducts its activities can create a conclusion as to how it will pay tax. The case of *Argosy Technologies*[22] illustrates this concept. The spouses who owned Argosy reported income and expenses on Form 1065, *U.S. Return of Partnership Income,* for several years. When faced with a partnership late filing penalty they attempted to argue Argosy was not a partnership but rather the spouses represented one member and should have been filing as an SMLLC. The court was not persuaded. Filing Form 1065 presented facts and circumstances that Argosy conducted its business operations as a partnership and therefore should be treated as a partnership. It is also worth noting that when an LLC is established with more than one member (in most states, husband and wife members of an LLC constitute more than one member),[23] the default IRS treatment is that the LLC follows partnership filing and compliance rules.[24]

17. Treas. Reg. §301.7701-2(c)(1).
18. *Election for Married Couples Unincorporated Businesses.* Jan. 6, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/election-for-married-couples-unincorporated-businesses] Accessed on Jul. 9, 2021.
19. Ibid.
20. As of May 2021, the nine community property states are: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin per IRS Pub. 555, *Community Property*.
21. Rev. Proc. 2002-69, 2002-45 IRB 831.
22. *Argosy Technologies, LLC v. Comm'r,* TC Memo 2018-35 (Mar. 22, 2018).
23. Rev. Proc. 2002-69, 2002-2 CB 831.
24. *Limited Liability Company — Possible Repercussions.* Mar. 15, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-possible-repercussions] Accessed on Jul. 9, 2021.

An entity's classification may be changed voluntarily or automatically when there is a change in the number of members or partners.[25]

Sole Proprietor (or SMLLC) to Partnership (or MMLLC)

IRC §761(a) states in part: "the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate." Legally, there are the following types of partnerships.[26]

1. **General partnerships** — all members participate in management and assume liability for the partnership's debts.
2. **Limited partnerships** — one partner assumes the role of general partner and the other partners may have limited management control and whose liability for partnership debts is limited to their investment.[27]
3. **Limited liability partnerships** — all partners are general partners but have liability only to the extent of their investment in the partnership.[28]

To define a partnership for tax purposes, the IRS references the number of partners,[29] and defines "limited liability" as a partner having no personal liability for the partnership's debts or claims.[30]

Example 5. Use the same facts as **Example 3.** In examining alternatives for the future of his tax firm, Kevin is approached by Every States Tax, LLC, an MMLLC. Kevin is offered a one-third ownership of the MMLLC. He believes a merger of this type may provide him with the means for a future exit strategy rather than trying to hire his own successor or sell outright to an unknown third party.

Note. After deciding to form a partnership, it is important to create a partnership agreement. Ideally, the agreement should include how the partners intend to work together and describe how they intend to share in profits and losses of the venture. It is equally important for the parties to discuss and include in their agreement how potential conflicts which may arise between the partners are to be handled as well as the procedures to withdraw from or terminate the partnership. Without the agreement, default rules of the state will apply.

25. Treas. Reg. §301.7701-3.
26. *General Partnership.* Corporate Finance Institute. [corporatefinanceinstitute.com/resources/knowledge/deals/general-partnership/] Accessed on Jul. 12, 2021.
27. Ibid.
28. Ibid.
29. Treas. Reg. §301.7701-2(c)(1).
30. Treas. Reg. §301.7701-3(b)(2)(ii).

Capital Interest[31]

A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at FMV and the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. The FMV of such an interest received by a partner as compensation for services must generally be included in the partner's gross income in the first tax year in which the partner can transfer the interest or the interest is not subject to a substantial risk of forfeiture.

Profits Interest[32]

A profits interest is a partnership interest other than a capital interest. If a person receives a profits interest for providing services to, or for the benefit of, a partnership in a partner capacity or in anticipation of being a partner, the receipt of such an interest is not a taxable event for the partner or the partnership. However, this does not apply in the following situations.

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.
- Within two years of receipt, the partner disposes of the profits interest.
- The profits interest is a limited partnership interest in a publicly traded partnership.

A profits interest transferred as compensation for services is not subject to the rules for restricted property that apply to capital interests. Taxpayers who receive a profits interest for services should consider the following points.

- A profits interest is also governed by IRC §83 and is similar to a capital interest except that a profits interest is only **in the income stream** and does not require a contribution of capital.
- A profits interest may also be subject to a substantial risk of forfeiture under §83(c)(1), and thus an election under §83(b) may be advisable.

If the partnership receives services and property in exchange for the partnership interest, then a reasonable allocation under IRC §721 is allowed.[33]

Capital Contribution

A transfer through capital contribution has no tax consequence if the transferor of the assets receives an interest in the partnership under §721. However, it is important to watch for the following circumstances.

- If the debt contributed, either encumbering contributed property or held by the partner and assumed by the partnership, exceeds the partner’s basis in the assets contributed, then the assumption of the debt is treated as a deemed money distribution to the partner.[34]
- If the amount of the deemed money distribution under IRC §731 exceeds the adjusted basis of the property contributed to the partnership, then the partner will recognize gain.[35]
- Under IRC §752(a), a partner’s proportionate share of debt is a money contribution and recourse debt is allocated based on the loss ratio,[36] while nonrecourse debt is allocated based on the profits ratio.[37]

---

31. IRS Pub. 541, *Partnerships.*
32. Ibid.
33. Rev. Rul. 64-56, 1964-1 CB 133.
34. Treas. Reg. §1.752-1(c).
35. IRC §731(a)(1).
36. Treas. Reg. §1.752-2(a).
37. Treas. Reg. §1.752-3(a)(3).

Basis of Capital Contribution. When assets are transferred as a capital contribution, the following Code sections govern treatment.

- Under **§721(a),** no gain or loss is recognized by the partner contributing property to the partnership, or by the partnership giving an interest in the partnership.
- Under **§721(b),** gain **is** realized on the transfer of property to a partnership if the partnership would be treated as an investment company under IRC §351(e)(1) if the partnership were incorporated.
- Under **IRC §722,** the basis of the contributing partner's interest is the sum of money contributed and the adjusted basis of the property contributed, where the adjusted basis is increased by any gain recognized under §721(b).
- Under **IRC §723,** the partnership assumes the adjusted basis of the partner contributing the property, including any gain recognized by the contributing partner.
- Under **IRC §724,** the holding period on any inventory that the partnership intends to hold as a capital asset is five years before the partnership may recognize capital gain.
- Under **IRC §704(c),** the difference between FMV and adjusted basis of the contributed property must be considered.[38] **Built-in gain** is the excess of FMV over adjusted basis at the time of contribution. **Built-in loss** is the excess of adjusted basis over FMV at the time of contribution.[39]

A small disparity between book value and adjusted tax basis may be disregarded when the book value of all contributed properties is less than 15% of the adjusted tax basis of those properties and is less than $20,000.[40] Otherwise, there are **three methods** for allocating built-in gain and built-in loss.[41]

1. The **traditional method** allocates the built-in gain or built-in loss to the contributing partner when the property is subsequently sold.
2. The **traditional method with curative allocation** is used to correct any distortion created by the ceiling rule of §704(c) by allowing a curative allocation of other partnership income, gain, loss, or deduction to enable equal allocations of book and tax items to be made to noncontributing partners.
3. The **remedial allocation method** is used to correct any distortion created by the ceiling rule for a noncontributing partner by allocating an amount of income, gain, loss, or deduction to a noncontributing member equal to the full amount of the limitation caused by the ceiling rule, offset by an allocation to the contributing partner.

> **Note.** The three methods of allocation are important and practitioners need to be aware of these items. The methods used are reported on the partner's Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* For more discussion on the three methods for allocating built-in gain and built-in loss, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Partners Issues and Chapter 5: Partnership Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

38. IRC §704(c)(1)(A).
39. IRC §704(c)(1)(C) and Treas. Reg. §1.704-3(a)(3)(ii).
40. Treas. Reg. §1.704-3(e)(1)(ii).
41. Treas. Reg. §1.704-3.

Inside and Outside Basis

Inside basis refers to the basis of assets held inside a partnership; **outside basis** refers to the value of each partner's interest in the partnership.

Example 6. Misty and Sally are interested in speculating in real estate. They form a partnership, and each contribute $200,000. Their new partnership then purchases a tract of land for $400,000. The value of the property increases in a relatively short period of time to $900,000. When presented with the value, Misty immediately decides she wants to take her money and run. She sells her 50% interest in the partnership to Jake for $450,000. Jake's purchase of Misty's interest gives him outside basis of $450,000, but his inside basis is limited to the 50% of the basis of the assets previously represented by Misty's share of the partnership assets, or $200,000.

Event	Inside Basis of Assets in the Partnership	Outside Basis of Partnership Interests
Misty and Sally each contribute $200,000 to the partnership for the purchase of a $400,000 plot of land	• Land: $400,000 • Misty: $200,000 • Sally: $200,000	• Misty: $200,000 • Sally: $200,000
• The land increases in value to $900,000 • Jake buys Misty's 50% interest for $450,000	• Misty: $0 • Sally: $200,000 • Jake: $200,000	• Misty: $0 • Sally: $200,000 • Jake: $450,000 purchase price (½ of $900,000)

Example 7. Use the same facts as **Example 6.** The partnership sells the land for the $900,000 appraised value.

Event	Inside Basis of Assets in the Partnership	Outside Basis of Partnership Interests
Partnership sells the land for $900,000	• Gain realized: $900,000 − $400,000 = $500,000 • Sally: $250,000 gain • Jake: $250,000 gain	• Sally: $200,000 + $250,000 gain = $450,000 • Jake: $450,000 + $250,000 gain = $700,000

Example 8. Use the same fact as **Example 7.** To prevent Jake from having to pay tax on a phantom $250,000 of gain, his alternatives include the following.

1. Liquidate the partnership: Jake recognizes a $250,000 loss ($700,000 outside basis – $450,000 to be received in liquidation).
2. Fully redeem Jake's interest: The partnership adjusts Jake's basis in the land in the year Jake buys Misty's interest. Jake receives a separate, additional inside basis in the land of $250,000 in addition to Misty's basis of $200,000. Thus, Sally would have an inside basis of $200,000 and Jake would have an inside basis of $450,000.
3. The partnership could make an IRC §754 election to adjust the inside and outside bases for the partners (described in detail later).

SMLLC MAKING A CORPORATE ELECTION

An SMLLC can elect to be taxed as a corporation. The corporate election can be as an S or C corporation for tax purposes. A sole proprietor can transfer an interest to a corporation by selecting one of the following methods.

- A sole proprietor can incorporate under state law.
- The incorporated entity can then make an election to be taxed as an S corporation.
- An existing SMLLC can elect to be taxed as a corporation or can make an election to be taxed as an S corporation.

Transferring Property in Exchange for Membership Units (Stock)

When an SMLLC elects to be treated as a corporation, the SMLLC is treated as transferring all its assets and liabilities in exchange for membership units (like shares of stock). The sole proprietor receives the membership units directly.

If §351 applies — meaning that the same person is in control under IRC §368(c) by possessing at least 80% of the total combined voting power of all classes of stock and at least 80% of the total number of shares of all classes of stock — and receives only stock in exchange for the transfer of property, no gain or loss is recognized on the transfer.

> **Example 9.** Use the same facts as **Example 5.** Kevin decides he is not ready to merge with another tax preparation firm. However, he is considering having his SMLLC make a corporate election to provide him other options for future consideration, such as the sale of stock instead of assets once he is ready to step away from the business. Kevin will remain the sole owner and shareholder if he decides to make this change.

The sole proprietor's assets and liabilities may be sold to, transferred to, or exchanged for stock with the new corporation. IRC §358 provides the rules for calculating basis.

If the sole proprietor makes a capital contribution under IRC §§118 and 362, the basis of the paid-in surplus is the transferor's basis.[42]

Boot. IRC §351(a) states that no gain or loss is recognized under IRC §1001(c) if property is transferred to a controlled corporation solely in exchange for stock. If the sole proprietor receives money or property (i.e., boot), though, they must recognize any gain, but not loss, under §351(b), up to the amount of realized gain under IRC §1001.

Even if there is a direct sale and the sole proprietor does not receive any stock, §351 should be considered, especially if the sole proprietor receives any boot. However, if only securities (i.e., promissory notes)[43] and no company stock are received in the transfer, §351 treatment is not available. The IRS position is that receiving debt securities in exchange for property does not qualify for §351 treatment when no stock is received and the recipient has not held any stock of the corporation prior to the exchange.[44]

> **Example 10.** Use the same facts as **Example 9.** If Kevin has his SMLLC make a corporate election, he read that he can transfer his assets to the corporate entity (rather than just contributing them). The corporate LLC can issue a promissory note for the FMV of the property contributed, including the value of his goodwill instead of issuing stock in exchange for the assets contributed. Kevin surmises that the issuance of the promissory note is an equal exchange of value and the nonrecognition rules of §351 will apply. The previous discussion indicates otherwise.

---

42. IRC §362(a).

43. See *Mills v. U.S.,* 399 F.2d 944 (5th Cir. 1968).

44. Rev. Rul. 73-472, 1973-2 CB 114.

Example 11. Emilio, a sole proprietor, transfers business personal property (e.g., office furniture, computer equipment) for which the adjusted basis is $8,000 and the FMV is $10,000 to a new C corporation in exchange for $9,000 of stock and other property with an FMV of $1,000.

Stock received	$ 9,000
Other property received (boot)	1,000
Total received and realized	$10,000
Less: adjusted basis of property transferred	(8,000)
Equals gain realized under IRC §1001(a)	$ 2,000
Gain recognized (lesser of boot received or gain realized)	$ 1,000

When a sole proprietor as transferor to a corporation receives boot, the character of each asset transferred determines whether the gain is ordinary income, or short- or long-term capital gain.

- **IRC §1239** requires the gain be treated as ordinary income where depreciable property was transferred to the corporation, and the sole proprietor holds more than 50% of the value of the corporation's stock under IRC §267(a).
- **IRC §1245** requires the recapture of post-1961 depreciation on property other than real property as ordinary income if the sole proprietor recognizes gain on the §351 transfer.
- **IRC §1250** requires the recapture of post-1963 gain on real property as ordinary income if the sole proprietor recognizes gain on the §351 transfer.

Although §351 does not mandate a business purpose for the exchange of property for stock, it is important to be aware that the IRS may disregard, disallow, or recharacterize a §351 transaction if it determines there was no business purpose for the transfer.[45]

Assumption of Liabilities. Under IRC §357(a), a corporation's assumption of a liability or acceptance of encumbered property does not qualify as boot under §351(b) because the debt assumed is not treated as cash or property. However, the assumption by the corporation of the sole proprietor's debt reduces the basis in the sole proprietor's stock.

Example 12. Zelda transfers business personal property (e.g., office furniture, computer equipment) with an adjusted basis of $8,000 and FMV of $10,000. However, there is $1,200 of debt owed on the business personal property. She transfers the assets and liabilities to a new C corporation in exchange for $8,800 of stock.

Stock received ($10,000 − $1,200)	$ 8,800
Liability assumed (not boot)	1,200
Total received and realized	$10,000
Less: adjusted basis of property transferred	(8,000)
Gain realized under IRC §1001(a)	$ 2,000
Gain recognized (lesser of $0 boot received or gain realized)	$ 0

Zelda's basis in the stock is $6,800 ($8,000 adjusted basis – $1,200 liability assumed) rather than the $10,000 FMV it would have been without the debt owed. She is likely to have capital gain on any subsequent sale of the stock. Under §362(a)(1), the corporation's basis in the property is $8,000 (i.e., the transferor's adjusted basis immediately prior to the exchange) rather than its $10,000 FMV.

Caution. IRC §357(c) requires the sole proprietor to recognize gain when the aggregate amount of liabilities transferred **exceeds** the aggregated basis of the property transferred, regardless of whether any gain is recognized. Thus, the sole proprietor may want to consider paying down the debt on any property to be transferred, or personally guaranteeing such debt rather than having the corporation assume the debt.

45. Rev. Rul. 55-36, 1955-1 CB 340.

S Corporation Qualifications

For an entity to be classified as an S corporation, it must meet **all** the following requirements.[46]

- Be a domestic corporation
- Have 100 or fewer shareholders
- Have only individuals and their estates — where members of a family may be treated as one shareholder[47] — or qualified trusts[48] as shareholders
- Contain no nonresident alien shareholders
- Have only one class of stock[49]

Members of a family include "a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant."[50]

Example 13. Stanley forms a C corporation under state law and plans to become an S corporation on the same date. He only needs to file Form 2553 on or before the 15th day of the third month following the corporation's start date.[51]

Similarly, if the SMLLC chooses to be taxed as a corporation and to make a timely S election concurrently, then Stanley only needs to file Form 2553 on or before the 15th day of the third month following the initial date the SMLLC is considered a corporation.[52]

Under IRC §1361(c)(6), **tax-exempt organization**s under IRC §501(c)(3) are also eligible shareholders after 1997. However, because these shareholders are already exempt from income tax—apart from their unrelated business income (UBI) — any income distributed to tax-exempt organizations is not passed through to the ultimate beneficiaries as it would be to individual shareholders, their estates, or under some qualified trusts.

46. IRC §1361(b).
47. IRC §§1361(c)(1)(A) and (B); Treas. Reg. §§1.1361-1(e)(2) and (3).
48. IRC §1361(c)(2)(A); Treas. Reg. §1.1361-1(h).
49. IRC §1361(b)(1).
50. IRC §1361(c)(1)(B)(i).
51. Treas. Reg. §1.1362-6(a)(2)(ii)(A).
52. Treas. Reg. §§1.1362-6(a)(2)(ii)(A) and §301.7701-3(c)(1)(v)(C).

LLC Taxed as a C Corporation Compared to LLC Taxed as an S Corporation

Below is a comparison of some of the potential advantages and disadvantages of the SMLLC retaining its election to be treated as a C corporation, and of electing S corporation treatment for tax purposes.

	C Corporation	S Corporation
Taxation [53]	Taxation on earnings and dividends at the corporate and shareholder level (double taxation)	Taxation on earnings and dividends at the shareholder level
Accumulated earnings tax	Possible when accumulated earnings are beyond reasonable business needs [54]	Not subject to accumulated earnings tax [55]
Capital loss deductions	To the extent of taxable income and may carry back and carry forward [56]	Shareholders may deduct losses to the extent of their basis in the corporation's stock and debt [57]
Reasonable compensation	Facts and circumstances could convert salary to dividend distribution if too high	Required for shareholder-employees [58]
Accounting method	If average annual gross receipts over three years is $26 million, must use accrual method of accounting [59]	May use cash method of accounting [60]
Qualifying dividend deductions	Can deduct 100% of qualifying dividends from domestic corporations under IRC §243(a)(3)	No deduction available
§1202 exclusion of gain from the sale or exchange of qualified business stock	If meets requirements [61]	Ineligible [62]
Built-in gains	Taxed upon distribution to shareholders	For S corporations that were converted from C corporations, taxed at the C corporation level and again at the shareholder level [63]
Qualified business income deduction (QBID)	No, but 21% flat tax [64]	Pass through to shareholder based on profit [65]

53. IRC §1363(a).
54. IRC §531.
55. IRC §1366(a)(1)(A).
56. IRC §172.
57. IRC §1366(d)(1).
58. IRC §1366(e).
59. IRC §§448(b)(3) and (c).
60. IRC §448(c)(1).
61. IRC §§1202(a)(1) and (c)(1).
62. IRC §1202(a).
63. IRC §1374.
64. *Tax Cuts and Jobs Act,* PL 115-97, §§11011 and 13001.
65. IRC §§199A(f)(1)(A)(i) and (ii).

Example 14. Roberto first forms a C corporation[66] or an SMLLC without choosing to be taxed as a corporation, and delays making the S election under IRC §1362(a). He must file the following forms to be taxed as a corporation.

- Form 8832 allows the SMLLC to choose to be classified as an association taxable as a corporation under Treas. Reg. §301.7701-3.
  - The entity may select the effective date of the election, up to 75 days prior to filing the election and 12 months after the election.
  - The entity may make the election by filing Form 8832 along with the entity's federal tax return for the year in which the election is effective.
  - If no effective date is indicated on Form 8832, the filing date is the effective date.
  - If the effective date is more than 75 days prior to filing, the effective date will be 75 days prior to filing.
  - The entity may not change its classification again for 60 months after its election's effective date.
- Form 2553 allows a corporation and any entity that may be treated as a corporation to make an S election.
  - The entity must make the election no later than two months and 15 days after the beginning of the tax year (starting on the first day of the tax year) for which the S election is to take effect, or anytime during the preceding tax year.[67]
  - For a late election, see Rev. Proc. 2013-30 for late filing relief procedures.[68]

Practitioner Planning Tip

For entities seeking to file only Form 2553, practitioners should consider filing within two months and 15 days of the start of the entity's tax year to comply with both deadlines for Forms 8832 and 2553.

66. Treas. Reg. §301.7701-2(b).

67. IRC §1362(b).

68. Rev. Proc. 2013-30, 2013-30 IRB 173.

TRANSFER BY SALE

This section discusses the disposition of the assets of an SMLLC when it is a disregarded entity. It next covers the sale of the LLC's membership units first as a disregarded entity with one member, then as the sale of an MMLLC's units when taxed as a partnership. Finally, the text discusses the sale of the LLC's units when it has elected to be taxed as a corporation.

DISPOSITION OF ASSETS BY AN SMLLC (DISREGARDED ENTITY)

Dispositions of assets used in an SMLLC disregarded entity are treated as separate property transactions and the amount and character of the gain or loss on the disposition is calculated based on each asset transferred.[69] The gain or loss is treated as ordinary income unless the property is a capital asset or eligible under §1231 for capital gain/loss treatment. The key Code provisions as found on Form 4797, *Sales of Business Property,* are as follows.

- IRC §1001(a) states that the "**gain from the sale or other disposition of property** shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011" and loss calculated as the excess of the adjusted basis over the amount realized.
- IRC §§1001(a) through (d) prescribe the general method for computing gain or loss, which starts with the amount realized and subtracts an amount to restore the adjusted basis. The excess of the amount realized over the adjusted basis is considered the gain. The shortfall is considered the loss.
- IRC §64 defines **ordinary income** as including "any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b)."
- IRC §280F(d)(4) defines **listed property** as assets that can be used for both personal and business purposes (e.g., passenger automobiles).

> **Note.** The types of assets considered listed property have steadily decreased over the past several years.[70] The basic premise of listed property is that by its very nature there is a factor of personal use even when the asset is a business-use asset. Because of this, listed property requires substantiation of the percentage of business versus personal use.

- IRC §1221 defines a **capital asset** as "property held by the taxpayer," but excludes property held "primarily for sale to customers in the ordinary course of [the] trade or business," subject to depreciation under §167, or real property.
- IRC §1231 provides for capital gains treatment of "property used in the trade or business" which is not held "primarily for sale to customers in the ordinary course of [the] trade or business."[71]
- IRC §1239 applies when the taxpayer sells property to an entity in which the taxpayer owns more than 50%, and the property is depreciable in the hands of the entity. Under these circumstances, capital gains on the depreciable property are treated as ordinary income to the seller.
    - In determining related parties, the related party and attribution rules of IRC §267(b) and (c) apply.

---

69. *Sale of a Business.* May 8, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/sale-of-a-business] Accessed on Jun. 30, 2021.

70. As of Jan. 1, 2010, cell phones and other personal-type communication devices were removed from listed property. As of Jan. 1, 2018, computers and peripheral equipment were removed from the listed property classification by TCJA.

71. IRC §1231(a)(1) provides for long-term capital gain/loss treatment; IRC §1231(b)(1) defines the property eligible for the long-term capital gain/loss treatment.

- IRC §1245 recaptures what would have been §1231 gain as ordinary income upon disposition of the §1245(a)(3) tangible personal property.
  - IRC §1245(a) takes the lesser of: (1) the recomputed basis (i.e., adjusted basis plus depreciation taken), or (2) the amount realized in a sale or involuntary conversion, and then subtracts the adjusted basis to calculate the amount of §1245 recapture.
  - IRC §1245(b) states that §1245(a) does not apply to gifts or to transfers at death. However, the donee of a gift must adjust the donee's basis in the property to reflect the adjusted basis of the donor immediately before the transfer.[72]

Example 15. Gretchen paid $12,000 for computer equipment solely for her personal use. After a year, she started a consulting practice, contributed all the computer equipment to her new business, and used it solely for her consulting business. Gretchen's basis when she changed the use of the computer equipment is her cost basis of $12,000.[73] The FMV of the contributed computer equipment was $10,000 as of the change-of-use date, and Gretchen subsequently took depreciation deductions of $1,000. Her adjusted basis after depreciation is $9,000. If Gretchen sells the computer equipment for $14,000, she will have a gain of $3,000 ($14,000 received – ($12,000 carryover basis – $1,000 depreciation)). If Gretchen sells the computer equipment for $5,000, she will have a loss of $4,000 ($5,000 received – $9,000 adjusted basis).[74]

- IRC §1250 is similar to §1245 but applies to real property — except for gifts, transfers at death, and certain tax-free transactions.[75]

Depreciation Considerations

When determining depreciation deductions or electing an accelerated depreciation method such as §179 or bonus depreciation for an active conduct of trade or business, the deduction appears on Schedule C or Schedule F. The income tax effect of these deductions is to reduce both income tax and SE tax.

When an asset is sold, the sale is reported on Form 4797 . Gains on the sale may be ordinary or capital in nature, but any gain from the sale of a business-use asset is not subject to SE tax. Even gain from deprecation recapture under §1245 is exempt from SE tax.[76]

In the case of a §179 expense election, when business use of an asset drops to less than 50% during its useful life, the difference between the elected §179 expense amount and regular depreciation (allowed or allowable) must be added back to Schedule C or F as ordinary income.[77]

---

72. Treas. Reg. §1.1245-2(c)(2).
73. Treas. Reg. §1.1012-1(a).
74. Treas. Reg. §1.1015-1(a)(2).
75. IRC §1250(d).
76. Instructions for Form 4797.
77. IRC §179(d)(10); Instructions for Form 4797.

Practitioner Planning Tip

Practitioners should consider the impact of currently saving both income and SE tax with whichever depreciation method is used, being mindful that there is only an income tax liability upon the future sale of the asset.[78]

An additional planning tip is to consider the impact of the QBID as provided during the Tax Cuts and Job Act (TCJA) years (2018 through 2025) when determining depreciation decisions. Claiming more or accelerating depreciation now reduces net profit, which reduces the QBID. Claiming less depreciation or electing less accelerated depreciation now increases net profit, which increases the QBID deduction.[79]

Note. For more information on depreciation and QBID, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Depreciation.

Note. Complete and accurate recordkeeping for the sole proprietorship is extremely important. Tax professionals who educate their sole proprietor clients about tax attributes of assets transferred to a business entity provide a beneficial service.

SALE OF A MEMBER'S INTEREST IN AN SMLLC (DISREGARDED ENTITY)

When the SMLLC remains a disregarded entity, the same rules apply to the sale of the interest as when the sole proprietor initially transferred assets to form the SMLLC. Income, loss, credits, and deductions are reported on the sole proprietor's Form 1040, Schedule C or on Schedule F, using one schedule per activity.

Dispositions of assets used in an SMLLC are treated as separate property transactions. From a tax perspective, the sale of an SMLLC interest is the same as the sale of the entity's assets. The amount and character of the gain or loss on the disposition is calculated based on each asset transferred. The gain or loss is treated as ordinary income unless the property is a capital asset or eligible under §1231 for capital gain/loss treatment. As mentioned previously, it is important to remember that assets transferred to the SMLLC retain the transferor's basis.

Example 16. Use the same facts as **Example 3.** Kevin decides to sell the assets of his sole proprietorship for $250,000. His business broker explains the purchase price is mostly allocable to his self-created goodwill and Kevin should just include equipment and furnishings as part of the price. The buyer wishes to allocate $5,000 to equipment and fixtures, to which Kevin agrees. His equipment and furnishings originally cost $7,000 and were fully depreciated. Under §1245, the $5,000 is reported as an ordinary gain. Kevin reports the remainder of the sales price, $245,000, as a long-term capital gain. Both transactions are reported on Kevin's personal tax return filing.

78. Instructions for Form 4797.

79. IRC §199A(b)(2)(B).

SALE OF A MEMBER'S INTEREST IN AN MMLLC

Under IRC §§741 and 1001, the transferor reports any gain on the sale or exchange of capital assets, except those subject to IRC §751 (unrealized receivables or inventory). It is important to be mindful of the following circumstances.

1. If a member sells an interest in an MMLLC (that has not elected to be taxed as a corporation) for cash and a share of the MMLLC's liabilities, then the seller realizes both the amount of cash and the reduction in the selling member's share of the MMLLC's liabilities.[80]
2. If a new member transfers property to the MMLLC that is taxed as a partnership and then receives a distribution shortly thereafter from the same MMLLC, the arrangement could be a **disguised sale** under IRC §707(a)(2)(B).[81]

Basis of Assets Sold

When assets are sold to the partnership, the partnership's initial basis is its purchase price of each asset.

Practitioner Planning Tip

It is important for practitioners to check the partnership agreement — or the operating agreement of an MMLLC — to see whether a §754 election is allowed. The election can be costly to administer and requires consecutive step downs in basis for assets that are declining in value.

The next section assumes that the MMLLC has not made an election to be treated as a corporation, so it will be referred to as a partnership in the rest of this section. When the partnership makes an adjustment of basis under IRC §754, there are important considerations. A §754 election provides a step up or step down to the partner's basis: **outside basis**, so it equals the partnership's basis; **inside basis**, by allowing depreciation and amortization deductions to be taken in the year the election is made, rather than waiting for the asset to be sold.

An election under §754 may be made only once, in a written statement timely filed with the partnership tax return for the year in which the property is distributed or the interest transferred.[82] The written statement must contain the name and address of the partnership, the signature of one of the partners, and a declaration that the partnership is electing under §754 to apply adjustments to both IRC §§743(b) and 734(b).[83] The §754 election is eligible for an automatic 12-month extension.[84] The election **may be revoked only with the consent of the IRS.**[85]

When the partnership makes an adjustment of basis under §743(b), there are important considerations. The adjustment of basis under §743(b) is **beneficial when the transferee's inside basis is less than outside basis.**

80. Treas. Reg. §1.752-1(h).
81. See *Otey v. Comm'r,* 70 TC 312 (1978) for a discussion of a capital contribution versus a sale.
82. Treas. Reg. §1.754-1(b). See IRC §6072(b) for the filing deadline of the 15th day of the third month after the close of the partnership's fiscal year.
83. Treas. Reg. §1.754-1(b)(1).
84. Treas. Reg. §301.9100-2(a)(2)(vi).
85. Treas. Reg. §1.754-1(c).

The imbalance between inside and outside basis is perhaps best illustrated by a transferee partner who receives an interest in the partnership upon the death of a partner. For example, if a partner received their partnership interest as an inheritance, under IRC §1014(a)(1), the transferee's basis (i.e., outside basis) is the FMV of the decedent's interest at death, decreased by any partnership income in respect of a decedent (IRD) under IRC §691(a). An example of partnership IRD is unrealized receivables.

After the partnership's basis (inside basis) is adjusted under §743(b) following a transfer of interest, the transferee's distributive share of partnership income, gain, loss, and deductions is adjusted pursuant to Treas. Reg. §§1.743-1(j)(3) and (4).

When the partnership makes an adjustment of basis under §734(b), it is important to consider the following outcomes. The purpose of §734(b) is to adjust the basis of the remaining partnership property after a **distribution** that requires recognition of a gain or loss under §731. Specifically, it is used when money is distributed in excess of the partner's interest,[86] or the tax basis of an asset changed for a nonliquidating distribution or for a liquidating distribution under IRC §§732(a)(2) and 732(b), respectively.

Reporting Partnership Basis. The reporting of partnership basis information is provided to partners as follows.

- The individual partner's shares of partnership income, gains, loss, and deductions are reported on Schedule K-1 (Form 1065).
- IRC §754 adjustments in the past were reported on line 13 of the Schedule K-1 (Form 1065). TCJA, which was signed into law on December 22, 2017, led to an updated Form 1065 and requirement that positive §743(b) basis adjustments are reported on line 11F of Schedule K-1, and negative §743(b) basis adjustments are reported on line 13V.[87]

Selling a partnership interest is akin to selling a capital asset,[88] apart from proceeds allocated to unrealized receivables or inventory (sometimes referred to as hot assets).[89]

IRC §741 states that the transferor-partner recognizes the gain or loss from the sale of the partnership interest — to either another partner or an outsider[90] — "as gain or loss from the sale or exchange of a capital asset" except for unrealized receivables and inventory covered by §751.

The amount of capital gain or loss is the difference between the amount realized and the adjusted basis of the partnership interest.[91] The **adjusted basis** of the partnership interest is calculated pursuant to IRC §705 as described next.

1. Begin with the basis under §722 (contribution to the partnership) or IRC §742 (transfer of partnership interest).
2. **Add:** the transferor-partner's distributive share for the current taxable year and all prior taxable years of:
   a. Taxable partnership income determined pursuant to IRC §703,
   b. Tax-exempt partnership income, and
   c. Excess of the deductions for depletion over the basis of the property subject to depletion.[92]

---

86. IRC §731(a)(1).
87. TD 9847, 2019-09 IRB 679.
88. IRC §741(a).
89. IRC §751(a).
90. Treas. Reg. §1.741-1(b).
91. Treas. Reg. §1.741-1(a).
92. IRC §705(a)(1).

3. **Subtract:** but not below zero, the transferor-partner's distributive share for the current taxable year and all prior taxable years of the following.

   a. Distributions received from the partnership under IRC §733 (i.e., money and property distributed to the partner under §732)

   b. Partnership losses

   c. Nondeductible partnership expenditures for computing taxable income and not properly chargeable to the capital account; and

   d. Deduction for depletion for any oil and gas property owned by the partnership up to the proportionate share of the partner's proportionate share of the adjusted basis of the property as allocated under IRC §613A(c)(7)(D)[93]

IRC §751(a) applies if any part of the sale or exchange of the transferor's entire or partial interest in the partnership (again, whether the transferee is an existing partner or an outsider) is attributable to unrealized receivables or to inventory.

IRC §751(b) applies if the transferor-partner receives any partnership property (e.g., money, unrealized receivables, inventory items which have appreciated substantially in value) as a distribution in exchange for all or part of the partner's interest in the partnership.

Practitioner Planning Tip

If a partner leaves and the business continues with the remaining partner(s), the practitioner must determine whether the remaining partner(s) bought the departing partner's interest, or the departing partner's interest was retired in exchange for a distribution.

A partner has a single, unitary basis in the partnership interest, even if the partner is both a general and a limited partner.[94] For a partial sale or exchange, a percentage of that basis commensurate with the transferor's share of the partnership assets being treated as sold is allocated to the sale or exchange.[95]

Sale or Exchange of the Partner's Interest When §751(a) Applies

Treas. Reg. §1.751-1(a)(2) provides the 2-step calculation for allocating the transferor's gain or loss from the sale or exchange of an interest in a partnership, when any part of the sale or exchange is attributable to unrealized receivables or to inventory, between ordinary income and capital gain or loss.

1. The transferor's share of the amount of gain or loss if the partnership had sold all its §751 property (including any adjustments under Treas. Reg. §1.704-3(d)) at FMV for cash is treated as ordinary income; and

2. The remainder of the transferor's realized gain or loss is treated as capital gain or loss.[96]

---

93. IRC §§705(a)(2) and (3).

94. Rev. Rul. 84-53, 1981-1 CB 159.

95. Treas. Reg. §1.61-6(a).

96. Treas. Reg. §1.751-1(a)(2) refers to Treas. Reg. §1.460-4(k)(2)(iv)(E) "for rules relating to the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting."

Under this approach, all premiums and discounts (e.g., lack of marketability, lack of control) reduce the amount of capital gain.

The transferor must file a statement with the transferor's tax return for the year of the transfer, providing the date of the transfer, the amount of gain or loss attributable to §751 property, and the amount of capital gain or loss.[97]

The transferee's basis is the amount paid[98] and includes the transferee's share of partnership liabilities.[99]

Distribution of Property to a Partner under §751(b). IRC §751(b) property consists primarily of unrealized receivables (§751(c)) and of inventory (§751(d)) that substantially appreciated more than 120% of its adjusted basis to the partnership.[100]

The partnership takes a cost basis in any §751 property purchased from the departing distributee.

Distribution of Property Within 7 Years of Contribution. It is important to be aware of the **distribution of contributed property within seven years** under §704(c)(1)(B). Under IRC §737, if the contributing partner receives property as a distribution within seven years of its contribution to the partnership, then that partner must recognize the built-in gain of the contributed property.[101] Built-in gain and built-in loss under §704 are discussed later.

Converting a General Partnership to an LLC

Converting a general partnership to an LLC is usually characterized as a continuation of the partnership and not as a termination under IRC §708.[102]

Converting a partnership interest in a domestic partnership to an interest in a domestic MMLLC (i.e., classified as a partnership) is considered a partnership to partnership conversion, and thus follows the rules set forth in Rev. Rul. 84-52.[103] The conversion does not cause a termination under §708 because each partner holds an interest in the LLC, and thus the conversion is not a sale.

See Rev. Rul. 99-6 for the analysis of moving from a MMLLC to an SMLLC.[104]

Converting a General Partnership to a Limited Partnership

As long as the business continues, the conversion of a general partnership to a limited partnership is not treated as a sale or exchange under §708.[105] Under §721, the partners do not recognize gain or loss under §§741 or 1001. There is no change to the holding period of any partner's interest in the partnership under IRC §1223(1).

If the partners' respective shares of partnership liabilities **do not change,** there is no change in the adjusted basis of their interests.

If the respective shares of partnership liabilities **change,** it may cause the following to occur.

- A deemed contribution of money to the partnership under IRC §752(a), and an increase under §722 of the partner's adjusted basis
- A deemed distribution of money to the partner under §752(b)

---

97. Treas. Reg. §1.751-1(a)(3).
98. IRC §1012.
99. IRC §752(d).
100. IRC §751(b)(3)(A).
101. Treas. Reg. §1.737-1(a).
102. Rev. Rul. 95-37, 1995-1 CB 130.
103. Ibid.
104. Rev. Rul. 99-6, 1999-1 CB 434.
105. Rev. Rul. 84-52, 1984-1 CB 157.

In this situation, the partner's adjusted basis decreases under §733 (but not to a negative amount) and the partner recognizes gain under §731 to the extent the amount received exceeded the partner's adjusted basis.

Conversion of a Partnership to a C Corporation

There are three ways for a partnership to become a C corporation owned by the same partners.[106]

1. The partnership **exchanges its assets for stock** in the corporation, which it distributes when the partnership liquidates.
2. The partnership **distributes its assets in liquidation of itself, and each partner then buys stock** in the corporation.
3. The partners **transfer their interests in the partnership to the corporation for exchange of stock**, such that the corporation now owns the partnership. The partnership then transfers its assets to the corporation, thereby liquidating the partnership.

IRC §351 provides rules regarding nonrecognition of gain or loss when the transferor is transferring a partnership interest to a corporation controlled by the same transferor.[107]

SALE OF THE ASSETS OF THE BUSINESS

When contemplating the sale of a business, attention must be given to what is being sold and how the sales price will be allocated between tangible and intangible assets. Selling the assets of an SMLLC, partnership, or S corporation, instead of the interest in the business, requires an evaluation of each asset with respect to its price and basis.

IRC §1060 and Allocation Rules

In the example running through this chapter, Kevin built a strong reputation and a core client base. If there is an expectancy of continued customer patronage upon the sale of the SMLLC, then there is arguably some **goodwill.**[108] As was described in earlier examples, the goodwill represented the largest percentage of the value of Kevin's business.

The proper allocation of the sales price between classes of assets is an important consideration and must be agreed to by both the seller and the buyer. A buyer might wish to allocate more of the purchase price to for example, furnishings and fixtures instead of goodwill. This creates greater current deductions (e.g., depreciation expense elections) for the purchase price as opposed to more of the purchase price being allocated to goodwill which is typically amortized over 15 years.[109] The seller, however, has an interest to allocate more of the selling price to goodwill, which, because it is self-created, receives long-term capital gain treatment.

Part of the continued patronage, though, may depend upon whether Kevin intends to start another venture after selling the SMLLC, and if there is a **covenant not to compete**. Goodwill is a capital asset to a buyer, but a covenant not to compete is treated as ordinary income by the seller. If the buyer and seller are adverse parties, then amounts allocated to goodwill and/or the covenant not to compete are usually accepted. However, the IRS can always challenge allocations that deviate from economic reality.[110]

The sole proprietor would also have to consider whether any **going concern value** exists if the business is likely to continue functioning or generating income without interruption despite the change in ownership.[111]

---

106. Rev. Rul. 84-111, 1984-2 CB 88.

107. Treas. Reg. §1.741-1(c).

108. Treas. Regs. §§1.197-2(b)(1), 1.1060-1(b)(ii).

109. IRC §197(a).

110. *Concord Control Inc. v. Comm'r,* 78 TC 742, 745 (1982).

111. Treas. Reg. §§1.197-2(b)(2) and 1.1060-1(b)(ii).

IRC §1060 was added in 1986 and mandates the residual method: valuing goodwill and going concern value as the amount of the purchase price that exceeds the FMV of all tangible and intangible assets other than goodwill and going concern value. Thus, the buyer and seller must now agree and allocate the consideration paid/received in the same manner among seven asset classes under Treas. Reg. §1.338-6(b) as follows.[112]

Class I. Cash and general deposit accounts

Class II. Actively traded personal property under IRC §1092(d), certificates of deposit and foreign currency

Class III. Assets marked to market at least annually and debt instruments other than contingent or convertible debt instruments and those issued by related persons

Class IV. Inventory used in a trade or business

Class V. All assets not included in Classes I, II, III, IV, VI, or VII

Class VI. All §197 intangibles except goodwill or going concern value

Class VII. Goodwill and going concern value

The reporting of the allocation is done on Form 8594, *Asset Acquisition Statement,* which is used for a group of assets that make up a trade or business. A blank Form 8594 follows.

112. Treas. Reg. §1.1060-1(c)(2).

Form **8594**
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your income tax return.
▶ Information about Form 8594 and its separate instructions is at *www.irs.gov/form8594*

OMB No. 1545-1021
Attachment Sequence No. **169**

Name as shown on return	Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I General Information

1 Name of other party to the transaction	Other party's identifying number
Address (number, street, and room or suite no.)	
City or town, state, and ZIP code	
2 Date of sale	**3** Total sales price (consideration)

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . ☐ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . ☐ Yes ☐ No

If "Yes," attach a statement that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 12-2012)

5

Part III **Supplemental Statement—**Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

Sale of an LLC Taxed as a Corporation

When an LLC taxed as a corporation is contemplating the sale of the business, it is important to determine what the taxpayer is selling. Questions to consider include the following.

- Will the sale be the membership units (stock) of the entity?
- Will the sale be of the entity's assets?
- Will the sale be a combination of membership units (stock) and assets?

For most members, the preferential treatment would be to sell membership units (stock) because in most instances the sale would result in capital gain treatment. Buyers, however, would likely not consider acquiring the membership units (stock) of a corporate entity for the following reasons.

1. The purchase price is tied up in the stock basis until the buyer liquidates the stock.
2. The purchaser "steps into the shoes" of the corporation which means there is no basis increase in corporate assets. The business continues as usual. In addition, by taking this approach the buyer will also assume existing liabilities of the corporation.

Conversely, a seller may be less motivated to consider the sale of business assets as these items may result in ordinary income tax treatment and perhaps double tax (as in a C corporation environment, illustrated next).

Example 17. Sale of an LLC Taxed as a C Corporation. Greg and Lisa's business is an established LLC taxed as a C corporation. They have been approached to sell their assets for $2,000,000. All their tangible corporate assets are completely depreciated, and the sales price is allocated $200,000 to tangible assets and $1,800,000 to the self-created goodwill Greg and Lisa have built over the years. All the sale proceeds are taxed at the C corporation level, which under current tax law is a flat 21%.[113] LLCs taxed as regular C corporations do not receive preferential capital gains treatment on the sale of intangible assets such as goodwill.[114] The issue then becomes one of how best (by minimizing the tax consequence) to get the sale proceeds after the corporate tax is paid into the hands of Greg and Lisa. The LLC could redeem their stock which will create a capital gain situation for them personally or the LLC could declare a dividend which would also be taxed in a similar manner as a long-term capital gain. If Greg and Lisa can convince the buyer to purchase their membership units (stock), there is one transaction at the personal level to account for.

The following table compares two potential arrangements for the sale of the business as a C corporation.

1. Sale of C corporation assets	$2,000,000		
Assumed basis in assets	(0)		
Taxable gain to the C corporation	$2,000,000	$2,000,000	
Corporate tax rate	× 21%		
Corporate tax	$ 420,000	(420,000)	$420,000
Cash remaining after federal corporate tax		$1,580,000	
Liquidating dividend or stock redemption	$1,580,000		
Assumed capital gain rate	× 20%		
Tax to shareholders assuming no basis	$ 316,000		316,000
Total federal tax cost of the transaction			$736,000
2. Sale of shareholder's stock	$2,000,000		
Assumed basis in assets	(0)		
Gain to shareholders	$2,000,000		
Maximum capital gains rate	× 20%		
Tax to shareholders	$ 400,000		(400,000)
Tax savings			**$336,000**

The difference in tax creates a bargaining scenario between the buyers and the sellers. The sellers may want a higher price to sell assets or be willing to settle for a smaller selling price if the buyer will purchase stock.

113. IRC §11(b).
114. IRC §§11(a) and (b).

Sale of the Member's Interest in an Incorporated SMLLC. The election on Form 2553 to be taxed as an association taxed as a corporation puts the SMLLC under the subchapter S rules. It is important to remember that the election effectively transfers the SMLLC's assets to the corporation — and thus the corporation's basis is the transferor's basis — in exchange for stock which is then distributed to the sole member of the SMLLC.[115] The member of the SMLLC becomes a shareholder of the corporation with respect to taxation.

Sale of the Shareholder's Interest in an S Corporation. The shareholder may either sell their shares back to the S corporation, in which case the operating agreement or a buy-sell agreement may set the terms of how the redemption price will be calculated; or negotiate a price for the shares.

Sale of Corporate Shares. The amount the selling shareholder receives, less the selling shareholder's basis, is the amount of gain or loss to be recognized. The selling shareholder's basis reflects the shareholder's contributions to the corporation, and income under IRC §1367(a)(1).[116] Basis must be reduced by any distributions the selling shareholder received and by any capital losses.[117] The shareholder's basis cannot go below zero.[118]

Example 18. Sale of an LLC Taxed as an S Corporation. Use the same facts as **Example 17,** except Greg and Lisa's business is an LLC taxed as an S corporation. The purchase/sale of corporate assets potentially creates both ordinary income and capital gain treatment as the sales price must be allocated between the tangible assets ($200,000) and the intangible assets ($1,800,000).

The following table compares two potential arrangements for the sale of the business as an S corporation.

1. Sale of S corporation assets				
Goodwill	$1,800,000	$1,800,000		
Fully-depreciated assets	200,000		$200,000	
Total assets	$2,000,000			
Assumed basis in assets	(0)			
Taxable gain	$2,000,000			
Corporate tax	$ 0			
Gains allocated to shareholders via Schedule K-1:				
Capital gains maximum rate		× 20%		
Tax on capital gains		$ 360,000		$360,000
Ordinary income maximum rate			× 37%	
Tax on ordinary income			$ 74,000	74,000
Total tax				$434,000
2. Sale of shareholder's stock	$2,000,000			
Assumed basis in assets	(0)			
Gain to shareholders	$2,000,000			
Maximum capital gains rate	× 20%			
Tax to shareholders	$ 400,000			(400,000)
Tax savings				**$ 34,000**

Gain is allocated to the shareholders regardless of whether a distribution of cash is made or not. The gain allocation to the shareholders increases their stock basis by $2,000,000, assuming the beginning year stock basis was $0. When cash is distributed, the stock basis is reduced to $0 again but creates no taxable event.

115. Treas. Reg. §301.7701-3(g)(1)(iv).

116. IRC §1367(a)(1).

117. IRC §1367(a)(2).

118. IRC §1366(d)(1).

In the LLC taxed as S corporation example, the only difference between the two sale strategies is in the ordinary income tax treatment of the previously fully depreciated tangible assets.

Note. The previous example does not illustrate the impact of the C corporation converting to an S corporation before the sale. The example presumed the S corporation was the entity selection since inception (or since corporate election from an original SMLLC). C corporations that convert to S corporations and then sells assets within **five years of conversion** will have the sale of assets taxed as though the entity was still a C corporation[119] (referred to as built-in-gains or BIG tax). For more information on the pros and cons of converting entities, see the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: C Corporations.

Practitioner Planning Tip

Practitioners may consider advising taxpayers organized as a C corporation to convert to subchapter S status before a potential sale to benefit from the preferential tax treatment illustrated previously. In a climate where C corporation tax rates may be increasing, advance planning before an anticipated sale is prudent.

Redeeming Shares. A distribution to a shareholder to redeem the shareholder's shares is treated as a sale or exchange under IRC §302(b) if the following occurs.

- The distribution is not essentially equivalent to a dividend.
- The selling shareholder's interest in the company performing the redemption is **substantially disproportionate** meaning:
  - Less than 80% of the shareholder's interest prior to the redemption, and
  - Less than 50% of the total combined voting power immediately after the redemption.

Failure to qualify as a sale or exchange under §302 will cause the redemption to be taxed under IRC §301 as a dividend to the extent of earnings and profits, then as a recovery of stock basis, then as a constructive sale of stock.

119. IRC §1374(b)(1).

TRANSFER BY GIFTING

Gifts of business interests to children in a family LLC (FLLC), a family limited partnership (FLP), or in an S corporation may be made for tax or for nontax purposes. A key question for gifting business interests in conjunction with estate planning is whether the parent-donor retains control over the FLLC or FLP, especially retaining any rights to income. If the parent-donor retains control, then the parent-donor risks inclusion of the retained interest in the parent-donor's gross estate for estate tax purposes under IRC §2036. However, retention of voting control and the transfer of nonvoting interests to children should not constitute the retention of a life estate within the meaning of §2036(b) in either a corporation or a partnership.[120]

If the parent-donor makes the transfer within three years of the parent-donor's death, then the value of the interest is includable in the parent-donor's gross estate under IRC §2035(a) and any gift tax paid on the transfer is includable in the parent-donor's gross estate under §2035(b).

If the parent-donor has a longer planning horizon, the parent-donor may consider gifting under the annual gift tax exclusion amount under IRC §2503(b)(1), which is updated annually in the fourth quarter; however, the exclusion under §2503(b)(1) applies only to gifts of **present interests.**[121]

This requirement culminated in the case of *Hackl v. Comm'r* wherein the taxpayers challenged the definition of future interest under Treas. Reg. §25.2503-3 and argued unsuccessfully that they had to be making gifts of present interests as they were giving up all their property rights in their shares. However, the LLC's operating agreement was drafted to prevent the donees from possessing any current economic benefit.[122]

> **Note.** One tactic whereby the child-donee receives a gift of a present interest in an entity may be to give the child-donee the power to sell the interest, subject to a right of first refusal by the entity. Another approach may be to allow the managing member to accumulate cash based on reasonable business judgment.

Married couples who are also donor-managers may choose to make a gift-splitting election pursuant to IRC §2513, which is reported on Schedules A, *Computation of Taxable Gifts,* and D, *Computation of Generation-Skipping Transfer Tax,* for Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*. Gift-splitting enables them to transfer present interests by combining their respective annual gift tax exclusion amounts, thereby transferring interests in the LLC twice as fast than if only one donor-manager made annual gifts.

The retained right to income alone under §2036(a)(1) can also bring the parent-donor's interest back into the parent-donor's gross estate.

GIFTING, VALUATION, DISCOUNTS, AND LIFETIME EXCLUSION

Any gift of business interests implies that the donor does not receive full and adequate consideration in return, as one would in an arms-length sale. IRC §2512(a) states that the value of the property on the date of the gift is the amount of the gift. Valuation is critical, not only of the business interest transferred, but of any applicable discounts. The principal discounts considered include minority interest, lack of control, lack of liquidity, and potential taxes.[123]

---

120. Rev. Rul. 81-15, 1981-1 CB 457.

121. See TAM 9131006 (Apr. 30, 1991) for allowance of a gift of an interest in a limited partnership to be considered as a present interest as long as the limited partners could withdraw from the partnership; TAM 199944003 (Jul. 2, 1999) for discussion of what constitutes a present interest in an FLP; and TAM 9751003 (Aug. 28, 1999) for disallowance of gifts of interest in a limited partnership as present interests where the general partner retained complete discretion regarding distributions of income.

122. *Hackl v. Comm'r,* 118 TC 279 (2002), *aff'd,* 335 F.3d 664 (7th Cir. 2003).

123. Rev. Rul. 59-60, 1959-1 CB 237 is the foundational guidance for valuing closely held corporations for estate and gift tax purposes. See also Rev. Rul. 93-12, 1993-1 CB 202 regarding the use of valuation discounts for LLCs and limited partnerships.

IRC §§2703 and 2704 have been the bases for IRS challenges to valuation discounts applied to transfers of interests in FLLCs and FLPs. IRC §2703 disregards restrictions on the uses or sale of property other than that in a business arrangement, and such arrangements must not be to transfer the property to members of the decedent's family. IRC §2704(b) disregards restrictions on the right to liquidate the FLLC or FLP. The IRS has generally been successful when the taxpayer has not properly formed and operated the entity per the customary formalities of segregating personal from entity finances and assets, maintaining minutes and records, making regular proportional distributions to owners, and otherwise complying with state law.[124]

Note. IRC §2704(b)(3)(B) states that applicable restriction does not include restrictions imposed by state law. Thus, if the operating agreement simply follows state law with regard to how the entity may be liquidated, then there is no applicable restriction and thus no discount for lack of ability to liquidate. An applicable restriction arises only when the operating agreement is more restrictive than state law with respect to liquidation.

An owner's ability to liquidate the entity without the consent of at least one other member or partner eliminates any valuation discount for federal estate or gift tax under §2704(a)(1) — even when the member's family owns the entity before and after the transfer.

The amount transferred by gift, whether valuation discounts apply or not, reduces the parent-donor's lifetime exclusion amount under IRC §2010(c)(3), which is updated annually in the fourth quarter.

Practitioner Planning Tip

The central planning question with clients is whether the children-donees are likely to be better off simply taking a step up in basis at the death of the parent-donor under IRC §1014.

TRANSFERS BY GIFT OF AN INTEREST IN AN FLLC

LLCs, including FLLCs, are either manager-managed or member-managed. All members enjoy the limited liability afforded by the LLC, which is a potential advantage over a partnership where the general partner(s) bear liability.

In a **manager-managed LLC,** the parents-owners who want to retain control over the business can give nonvoting or nonmanagerial interests to their children. The parents-owners-managers retain control over operations — even if their 1% ownership stake is vested with 100% managerial control. By gifting nonvoting or nonmanagerial interests to the children, the children's interests may be discounted for lack of control and for lack of marketability. As distributions are made in proportion to ownership interests, more of the net income flows through to the children who are more likely to be in a lower income tax bracket.

The potential limit to the usefulness of this approach from a tax perspective is that valuation discounts reduce the donee's basis in the interest under IRC §1015, thereby increasing the potential for capital gain upon subsequent sale of the interest.

A **member-managed LLC** is usually the default for SMLLCs. For MMLLCs, member management allows all the members to participate actively in operations and in management. Thus, it is important to consider nontax circumstances regarding how the FLLC is likely to work in practice.

124. *Estate of Strangi v. Comm'r,* 115 TC 478 (2000), *aff'd in part, rev'd in part, Gulig v. Comm'r,* 293 F.3d 279 (5th Cir. 2002).

The donee's basis in the gifted interest is the FMV of the donor's interest in the FLLC, reduced by the donor's share of the FLLC's liabilities, and increased by the portion of the gift tax paid on the net appreciation of the donor's interest up to the FMV of the interest.[125]

- If the amount of debt relief exceeds the FMV of the donor's interest in the FLLC, then the part gift/part sale rules apply: the debt relief is realized as part of the deemed sale and the donor recognizes gain.[126] The gain is added to the donor's basis, which becomes the donee's basis.[127]
- If the donor's basis is greater than the FMV of the donor's interest in the FLLC, the donee's basis is the FMV of the donor's interest in the FLLC.[128]

If the gifted interest is in an LLC taxed as a corporation, there is no debt relief because the gift is deemed a gift to shareholders, and shareholders may not enjoy a present interest unless the corporation is liquidated or pays a dividend.[129]

TRANSFER BY GIFT OF AN INTEREST IN A PARTNERSHIP

Because TCJA eliminated technical terminations for tax years after 2017, a gift of a partnership interest is not a sale or exchange for the 50% test under §708, and thus does not terminate the partnership.[130]

The transferee takes the partnership interest subject to the carryover basis under §1015: the donor's basis adjusted by gift tax paid on unrealized gain under §1015(d)(6).

IRC §704(e) states the requirements for a donee, who is also a family member, to qualify as a member of the partnership. The requirements under Treas. Reg. §1.704-1(e)(1) include **all** the following.

- The donor must be reasonably compensated for any services provided to the partnership.
- The members — donor and donee — must receive a share of the income commensurate with their capital interests.
- The transfer must not be a sham transaction.
- Capital, not simply services and fees, must be a material income-producing factor.
- The donee must receive a capital, not a profits-only interest.

If a partnership interest is created by a gift, then the transferee's distributive share is included in the transferee's gross income except to the extent that the share meets the following requirements.

- Fails to allow for reasonable compensation that the transferor provided to the partnership, and
- The gifted capital is greater than the transferor's share of contributed capital.[131]

Under §704(e)(2), if a family member purchases an interest in a partnership from another family member, then the interest is considered as a gift from the seller and the FMV of the purchased interest is considered as donated capital.

TRANSFER BY GIFT OF SHARES IN AN S CORPORATION

A critical planning point with respect to LLCs making an S corporation election is to monitor the subsequent recipients of shares in the S corporation to avoid inadvertent termination under §1361(b). The entity's operating agreement may have restrictions on the transfer of shares to protect the entity against inadvertent termination of the S election.

---

125. IRC §§742 and 1015. See especially IRC §1015(d)(6) and Treas. Reg. §1.1015-5(c).

126. Treas. Reg. §1.1001-2(a).

127. Treas. Reg. §1.1015-4(a)(2).

128. IRC §1015(a).

129. Rev. Rul. 71-443, 1971-2 CB 337.

130. *Questions and Answers about Technical Terminations, Internal Revenue Code (IRC) Sec. 708.* Sep. 24, 2020. IRS. [www.irs.gov/newsroom/questions-and-answers-about-technical-terminations-internal-revenue-code-irc-sec-708] Accessed on Jun. 23, 2021.

131. IRC §704(e)(1).

TRANSFER BY INHERITANCE OR BEQUEST

Neither the decedent's estate transferring the decedent's interest in an entity, nor the recipient of an interest in an entity by inheritance or bequest recognizes income or loss on the value of the interest itself. The beneficiary's basis is the FMV of the interest at the decedent's date of death or on the alternate valuation date if chosen by the personal representative of the estate.[132]

QSST AND ESBT DURING PERIOD OF ADMINISTRATION

Until 1976, all shareholders of an S corporation had to be individuals. In 2021, a grantor trust,[133] a voting trust,[134] a qualified subchapter S trust (QSST), and an electing small business trust (ESBT) may all qualify as shareholders of S corporations.

QSST Requirements

A QSST has the following requirements pursuant to IRC §1361(d)(3)(A).

1. The trust can have only one income beneficiary at a time, and the beneficiary must be a U.S. citizen or resident.
2. Distributions of trust corpus must be made only to the income beneficiary.
3. The income interest must terminate on the earlier of the beneficiary's death or the trust's termination.
4. If the trust terminates during the income beneficiary's life, trust assets must be distributed to the beneficiary.

The QSST may hold S corporation stock if the individual income beneficiary elects to be treated as the owner of the QSST and the S corporation shares for federal tax purposes under IRC §678.[135] However, Treas. Reg. §1.1361-1(j)(8) states that the trust is considered an S corporation stock owner if the QSST disposes of the stock.

A QSST may convert to an ESBT.[136]

Practitioner Planning Tip

In the case of a family-owned S corporation where the parents own all the stock, gifting to children utilizing a QSST for each child can be an important estate planning tool especially if the goal is to sell the business in the next five to seven years. The children receive fractional, nonvoting interests while the parents retain control. When an eventual sale occurs, all shareholders may then be eligible for capital gain treatment.

132. IRC §1014(a).
133. IRC §§671–678.
134. IRC §1361(c)(2)(A)(iv); Treas. Reg. §1.1361-1(h)(1)(v).
135. IRC §1361(d)(2).
136. Treas. Reg. §1.1361-1(j)(12).

ESBT Requirements

An ESBT qualifies to hold S corporation stock pursuant to §1361(e) if all the following apply.

1. The trust's sole beneficiary is an individual, an estate, or a tax-exempt entity.
2. No interest in the trust was purchased — meaning the interest in the ESBT must be acquired by gift or bequest.

The trustee must make the ESBT election by the 15th day of the third month after the trust becomes a shareholder. Each potential current beneficiary of the ESBT counts as one shareholder with respect to the S corporation's 100-shareholder limit.[137]

For income tax purposes, the portion of the ESBT containing S corporation stock is treated as a separate trust in which the following apply.

- The income attributable to the S corporation is taxed at the highest rate for trusts and estates.
- Deductions for capital losses are allowed only to the extent of capital gains.
- No deduction is allowed for distributions to ESBT beneficiaries and the ESBT's income is not included in the DNI of the ESBT.
- The ESBT's alternative minimum tax (AMT) exemption amount is zero.[138]

An ESBT may convert to a QSST.[139]

Qualified Subchapter S Subsidiary (QSub) Election

Taxpayers may want to segregate an S corporation's distinct trades or businesses, but not have each entity treated as separate from the S corporation parent. IRC §1361(b)(3)(B) defines a QSub as a domestic corporation that meets the following requirements.

- Is not ineligible (i.e., is not a bank using the reserve method of accounting under IRC §585, an insurance company taxed under subchapter L, or a current of former domestic international sales corporation (DISC)).
- The S corporation owns 100% of the stock.
- The S corporation parent makes the election to treat the corporation as a QSub.

The QSub election is made by the S corporation parent filing Form 8869, *Qualified Subchapter S Subsidiary Election*. The election may be made any time during the tax year.[140] The effective date of the election may be no earlier than two months and 15 days prior to filing or later than 12 months after filing.[141] The election allows all assets, liabilities, income, deductions, and credits to be tax attributes of the S corporation parent.[142]

---

137. IRC §1361(b)(1)(A).
138. IRC §641(c); Treas. Reg. §1.641(c)-1.
139. Treas. Reg. §1.1361-1(m)(7).
140. Treas. Reg. §1.1361-3(a)(3).
141. Treas. Reg. §1.1361-3(a)(4).
142. Treas. Reg. §1.1361-4(a)(1).

BASIS

A decedent's estate values the decedent's interests as of the date of death, or at the alternate valuation date (AVD) six months after death.[143] If the personal representative elects to use the AVD, then the value of **all** the decedent's interests are valued as of the AVD, and the election must decrease the value of both the gross estate and the estate tax.[144] The AVD value applies even to assets that are distributed to beneficiaries during the six months following the decedent's date of death.[145]

> **Note.** State law and corporate governance documents are critical to determine what functions a personal representative is authorized to perform when the personal representative "steps into the decedent's shoes." Usually, the estate and the personal representative are limited to receiving information regarding the decedent's interest **in** the entity. Too often, personal representatives and beneficiaries assume they are automatically eligible to participate in management of the entity.

SMLLC (Disregarded Entity)

Unless the SMLLC operating agreement or other contract specifies a successor in interest, state law usually classifies the deceased single member's interest in the SMLLC as the member's personal property, which becomes part of the decedent's estate. SMLLC assets thereby receive a step up in basis under §1014. The estate assumes responsibility for resolving the SMLLC's liabilities.

If the SMLLC was following the formalities of operating as a business and did not elect to be taxed as a corporation, then estate administration usually involves winding up the business as a separate entity and transferring the remainder to be distributed as part of the residue of the estate. The decedent's estate may need to loan funds to the SMLLC to complete the winding up.

> **Note.** If the single member dies or is incapacitated, that member's legal representative usually has all the power of an assignee or transferee of the single member. Unless the operating agreement says otherwise, an assignee usually does not have the right to inspect the LLC's books. Successors usually have only economic rights unless admitted as a member to the LLC under state law.

Partnership (if Decedent's Interest is Assumed by Other Partners)

A partner's death is usually considered a dissociation from the partnership, not a sale or exchange.[146] A specific bequest of a partnership interest does not terminate the partnership.[147]

The deceased partner's successor in interest receiving payments under IRC §736 is treated as the partner until the deceased partner's interest is fully paid out.[148]

If surviving partners must acquire the deceased partner's interest, the acquisition is a sale or exchange.[149]

The transferee's basis in the interest is valued at the decedent's date of death value (or AVD value) plus partnership liabilities less decedent's share of partnership assets generating income in respect of a decedent under §691.

---

143. IRC §§1014 and 2032.

144. IRC §§2032(a) and (c).

145. IRC §2032(a)(1) and Treas. Reg. §20.2032-1(c) for definitions of "distributed," "sold," "exchanged," etc.

146. Treas. Reg. §1.708-1(b)(1)(ii) pointing to Treas. Reg. §1.736-1(a)(6).

147. IRC §663(a)(1) and Treas. Reg. §1.663(a)-1(b)(2).

148. Treas. Reg. §1.736-1(a)(6).

149. Treas. Reg. §§1.708-1(b)(1)(ii) and 1.736-1(a)(6).

S Corporation

An S corporation's basis in its assets is not increased or decreased due to the transfer of stock by sale or death, or from distributions to shareholders.

If the S corporation liquidates and distributes assets in the same year as the decedent's death, then the distribution is treated as a sale in exchange for the decedent's S corporation stock.[150]

If the S corporation simply sells assets, the inside basis of those assets is unaffected by the decedent's death. In this case, the S corporation is likely to have taxable gain, which it then passes to the shareholders who inherited the decedent's S corporation stock. These shareholders are taxed at their personal capital gains rate.

INVOLUNTARY TRANSFER BY BANKRUPTCY OR REORGANIZATION

Filing a bankruptcy petition creates a bankruptcy estate.[151] In a Chapter 7 bankruptcy, the trustee liquidates the debtor's nonexempt assets to pay creditors. In a Chapter 11 or 13 bankruptcy, the debtor-in-possession reorganizes.[152] When a trustee is appointed, the trustee assumes all the rights and interests of the bankrupt member, partner, or shareholder — economic as well as managerial and voting. Any limitations in the operating agreement or partnership agreement are unenforceable because the trustee is not treated as an assignee or transferee of the bankrupt member or partner's interest.[153]

Note. For more details on the various types of bankruptcy, see the 2021 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Financial Distress.

In 2019, the Small Business Reorganization Act (SBRA) created a process under Chapter called "subchapter V", where the "V" means five, that simplifies the restructuring process for businesses with less than $2,725,625 in debt. Section 1113 of the CARES Act temporarily raised the limit under the SBRA to $7.5 million in debt, as long as at least half of the business debt arose from business or commercial activities.

BASIS OF AN SMLLC TO THE BANKRUPTCY ESTATE

The bankruptcy estate includes the bankrupt owner's interest in the SMLLC, and thus the single member's basis in the assets of the SMLLC. The bankruptcy trustee under a Chapter 7 bankruptcy by the single member could seek to void transfers of personal assets to the SMLLC.

BASIS OF A PARTNERSHIP TO THE BANKRUPTCY ESTATE

Under IRC §1398(f)(1), the transfer of a partner's interest to the partner's bankruptcy estate is neither a sale or exchange that closes the partnership's taxable year under IRC §706(c)(2)(A)(i),[154] nor a change in the partner's interest under §706(d).[155] Thus, all items of income, gain, loss, deduction, and credit should be allocated to the bankruptcy estate under §1398(g). Likewise, the basis, holding period, and character of assets all pass to the bankruptcy estate under §1398(g).

150. IRC §336.
151. 11 USC §§541(a)(1)–(5).
152. 11 USC §542(a).
153. 11 USC §541(c)(1)(B).
154. IRC §1398(f)(1).
155. Ltr. Rul. 9304008 (Oct. 27, 1992).

BASIS OF AN S CORPORATION TO THE BANKRUPTCY ESTATE

The S election is only for tax purposes, so bankruptcy filed by the corporation or by an individual shareholder is treated according to the rules for corporations or for individuals.

BASIS OF AN SMLLC AFTER THE BANKRUPTCY ESTATE

IRS Pub. 908, *Bankruptcy Tax Guide,* is one starting point to calculate the basis of an SMLLC after the bankruptcy estate. Treas. Reg. §1.1017-1 states that if IRC §1398 applies to an individual filing a Chapter 7 or 11 bankruptcy, and if the bankruptcy estate holds property subject to a basis reduction under IRC §108(b)(2)(E) on the first day of the taxable year following the year of discharge, then the bankruptcy estate must reduce all of the adjusted bases of its property before the taxpayer reduces any adjusted bases in property.

IRC §1398(f)(1) states that the transfer, other than by sale or exchange of an asset from the debtor to the bankruptcy estate, is not treated as a disposition of the asset. IRC §1398(g) states that the bankruptcy estate succeeds to the tax attributes of the debtor.

BASIS OF A PARTNERSHIP AFTER THE BANKRUPTCY ESTATE

The transfer of a partnership interest pursuant to any reorganization, other than an F reorganization, under §§361 and 368(a)(1) is treated as an exchange of the partnership interest for purposes of the termination provisions.[156] A partnership will typically not continue in operation after a bankruptcy filing although the individual partners may still be liable for partnership debts.[157]

BASIS OF AN S CORPORATION AFTER THE BANKRUPTCY ESTATE

IRC §351(e)(2) states that §351(a) does not apply to the transfer by a debtor in bankruptcy of assets to a corporation to the extent the stock received is used to satisfy the debts. The transfer by the bankrupt debtor to a corporation generates recognized loss. The transfer of the stock to creditors to discharge debts reduces potential discharge from indebtedness income equal to the amount of debt less the cost basis of the stock.

OTHER ISSUES

Debt Cancellation

Generally, for an individual, cancellation of debt, other than the exceptions under §108, results in gross income under §61(a)(11).

When a partnership realizes cancellation of debt, the insolvency exclusion under §108(a)(1)(B) applies at the partner level.[158] Under Rev. Rul. 2012-14, the individual partners may include excess nonrecourse debt from the partnership to the extent it is cancelled in the calculation of the individual partner's insolvency.[159]

For an S corporation, the taxable portion (i.e., after any exclusions under §108) is passed through to shareholders on Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*, on line 10, Other income.

156. Rev. Rul. 87-110, 1987-2 CB 159.

157. Treas. Reg. §1.752-2.

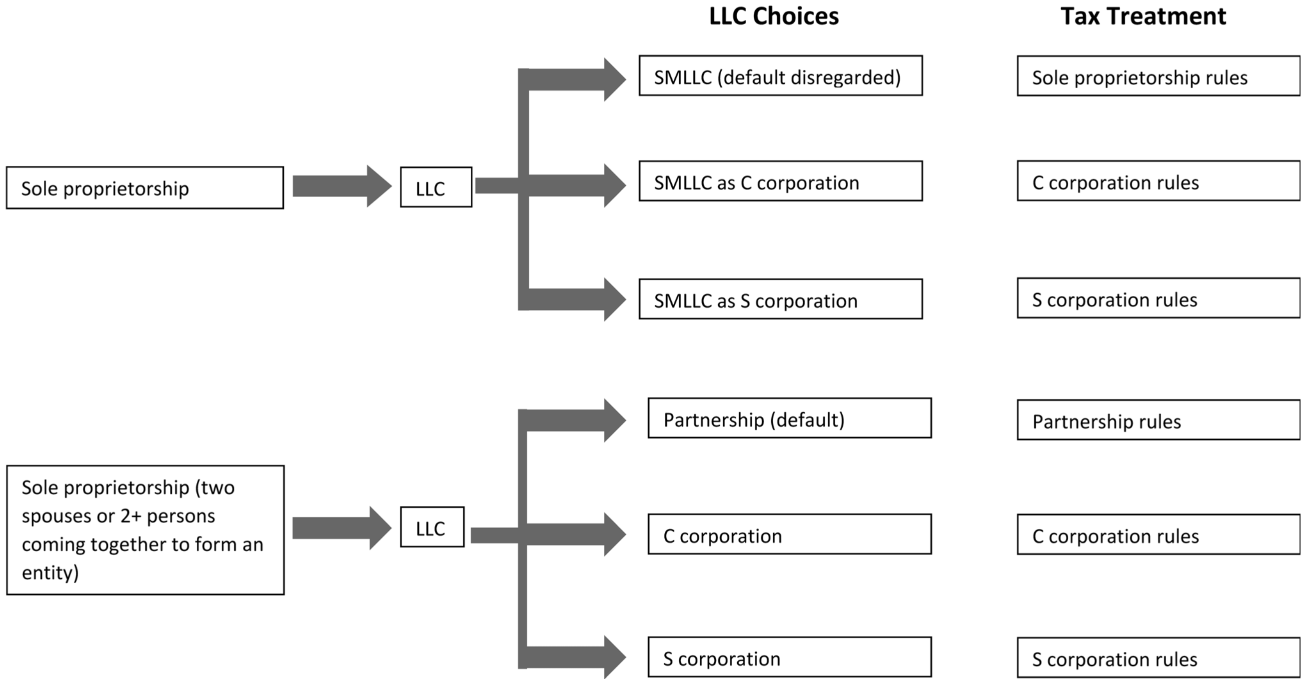
158. IRC §108(d)(6).

159. Rev. Rul. 2012-14, 2012-24 IRB 1012.

APPENDIX

TRANSFER FLOWCHART

The following flowchart visually portrays the various entity choices available when sole proprietorship(s) transfer to an LLC, and the resulting tax treatments.



TAX ISSUES WHEN TRANSFERRING FROM AN LLC ENTITY ELECTION BACK TO A SOLE PROPRIETORSHIP

Entity Type	Sole Proprietorship Tax Issues
Single Member LLC	
SMLLC (default disregarded)	None
C corporation-LLC	Treated as corporate dissolution and assets treated as a sale at FMV
S corporation-LLC	Treated as corporate dissolution and assets treated as a sale at FMV
MMLLC	
Partnership	Partnership dissolution rules
C corporation-LLC	Treated as corporate dissolution and distributed assets treated as sold at FMV
S corporation-LLC	Treated as corporate dissolution and distributed assets treated as sold at FMV

SAMPLE TRANSFER QUESTIONS TO ASK THE CLIENT

Questions to Consider about Transferor	Answers and Notes
Who is the transferor? (e.g., individual, agent with a power of attorney (POA), personal representative of a decedent's estate?)	
Does the transferor have authority to make the transfer? (e.g., ownership interest, controlling interest, written authority to act?)	
What documents are available to examine? (e.g., corporate governance documents, POAs, deeds, titles, recorded documents of ownership, letters testamentary or of administration?)	
Is the transferor a U.S. citizen or legally present resident (e.g., green card holder)?	

Questions to Consider about Transferee	Answers and Notes
Who is the transferee? (e.g., sole proprietorship, partnership, SMLLC, S or C corporation—consider whether any partner/member/shareholder has a marital, familial, special relationship with transferor. Is the transferee a minor? A U.S. citizen?)	
How will transferee take the interest? (e.g., outright, in trust, subject to precedent or subsequent actions, will transferee have powers of appointment – either general or limited? What documents need to be reviewed?)	
Will transferee be a partner or a co-owner with transferor?	
Will transferee be active participant or passive investor?	
Does transferee require any special licensing or permits to be able to receive, deal, or hold the interest? (e.g., firearms-related business, marijuana-related business, liquor license, etc.)	

Questions about What is Being Transferred	Answers and Notes
Does the transfer involve an asset? (e.g., is the asset encumbered by a related party or third party; is there potential for assignment of asset?)	
Does the transfer involve an equity interest? (e.g., voting rights, rights to participate in management activities?)	

Questions about Where Assets/Interests are Based	Answers and Notes
Location of asset/interest? (e.g., in one or more U.S. jurisdictions, outside U.S. jurisdictions?)	
Foreign bank accounts or trusts involved? (e.g., as source of capital or revenue, as recipients of dividends or payments?)	
Foreign assets involved? (e.g., located outside U.S. jurisdictions, owned by non-U.S. citizens?)	

Questions about Why Transfer is Being Made	Answers and Notes
Is the transfer part of a succession plan or a result of no succession plan?	
Is the transfer due to a good price or deal being offered?	
Is the transfer a completed gift?	
Is the transfer due to a desire to bring family member into business or to provide future security for select individuals?	
Is the transfer being used to exert "dead hand control" (transferor places highly detailed conditions on transfer that transferor effectively controls the use of asset or interest after transferor is deceased)?	
Is the transfer being made to satisfy creditors and wind up operations in bankruptcy?	

Questions about Prior Transfer of Interest	Answers and Notes
Was a prior transfer made? (e.g., how frequently has interest been transferred, is there information about the basis at each transfer?)	
What are expectations for future transfers? (e.g., short-term—back and forth between parent-child-parent, long-term—funding dynasty trust, is there a holding period?)	

5

Questions about How Interest is Transferred	Answers and Notes
Sale? (e.g., cash, in-kind, installment?)	
Gift? (e.g., must be of present interest)	
Part gift/part sale? (e.g., what is transferor's basis?)	
Inheritance? (e.g., what is beneficiary's basis?)	

Questions about How Interest is Valued	Answers and Notes
Book value or fair market value (FMV)?	
Discounts applied for lack of control or marketability?	
Formal IRS-recognized appraisal?	
How will valuation be reported to IRS? (e.g., Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return* ?, Form 709?)	