DEALING WITH UNCLE SAM,
EVERYONE'S LEAST FAVORITE RELATIVE IN THE FAMILY BUSINESS

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I. INTRODUCTION

A. SCOPE OF MATERIALS

These materials are intended as a primer on basic business tax issues most relevant to the closely-held enterprise that's already operating as a going concern. These materials are not concerned with the "choice of entity" question facing entrepreneurs at the inception of the business. There are many other excellent, comprehensive resources to assist planners at the inception of the business. See, e.g., Dwight Drake, BUSINESS PLANNING: CLOSELY HELD ENTERPRISES (5th ed. 2018); Richard A. Shaw and Thomas J. Nichols, *Choice of Entity in Light of Recent and Proposed Tax Changes*, 68 NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION, Ch. 13 (2010); Richard A. Mann, Michael O'Sullivan, Larry Robbins, and Barry S. Roberts, *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773 (2004).

Instead, these materials offer a brief overview of the basic income tax mechanics of each entity form and a discussion of several particular estate planning strategies available (and the particular pitfalls present) depending on the entity that walks through the door with the client. We are not concerned here with whether the client should do business as a corporation or partnership; rather, we are concerned with what to do once the business has already been operating for some time and has proven successful. The answers to that question often depend on the form in which the business operates. These materials do not address strategies applicable to all closely-held business interests. The installment payment of federal estate tax attributable to closely-held business interests under IRC §6166, for example, is not covered in these materials because this benefit applies to C corporations, S corporations, and partnerships. Instead, these materials focus on techniques that are unique to certain of the entity forms.

B. THE INTERNAL REVENUE CODE SEES ONLY THREE ENTITIES

A client's business will almost always come in one of seven forms: (1) a sole proprietorship; (2) a general partnership; (3) a limited partnership; (4) a limited liability partnership; (5) a limited liability company; (6) an S corporation; and (7) a C corporation. For

federal tax purposes, however, there are only three types of business entities. The first form described above (sole proprietorship) is simply disregarded for federal tax purposes, so all items of income and deduction attributable to the business are added to the owner's other items of income and deduction on his or her (or their) Form 1040.

The next three forms (general partnership, limited partnership, limited liability partnership) are treated as partnerships for federal tax purposes, meaning they will subject to the marvelous complexities of Subchapter K. Any of these three forms are welcome to elect corporation status, but that is rarely done for domestic entities.

The fifth form, the limited liability company, will be treated as a sole proprietorship for federal tax purposes if it has only one owner; if it has multiple owners it will be treated as a partnership unless the owners elect to have the entity taxed as a corporation.

The last two forms, the corporations, have no choice. From a federal tax perspective, they are corporations and nothing else. Of course, an S corporation is a pass-through entity, meaning that the entity will generally not be liable for payment of federal income tax. The items of income, gain, loss, deduction, and credit of an S corporation are attributed to its shareholders in proportion to their ownership interests as if they derived such items themselves (though the character of any given item is determined at the entity level). Subsequent distributions of after-tax earnings from the S corporation are not again subject to tax as dividends. This is the major distinction between S corporations and C corporations. C corporations are separate taxable entities. Their taxable incomes are subject to a different progressive rate table, and distributions of after-tax earnings and profits are gross income to the recipient shareholders. Under current law, this "double tax" is mitigated to some extent because dividends received from domestic corporations and certain foreign corporations are taxed at the same rate as net capital gains (*i.e.,* at zero percent, 15 percent, or 20 percent, though the latter two rates will be 3.8 percent higher where the IRC §1411 surcharge on net investment income applies). This preferential rate for "qualified dividend income" applies to dividends on common and preferred shares from both closely-held and publicly-traded corporations.

II. C CORPORATIONS

A. THE BASIC MECHANICS

1. Formation

From a tax perspective, forming a corporation is one of life's easier tasks. Generally, a taxpayer will not have to recognize gain on the transfer of property to a corporation solely in exchange for shares of the corporation's stock. IRC §351(a). Taxpayers will have to recognize any realized gain, however, if: (1) they receive property from the corporation in addition to the corporation's stock, IRC §351(b); (2) they do not own at least 80 percent of the corporation's stock, IRC §351(a); (3) they contribute services (rather than property) to the corporation, IRC

§351(d); or (4) the amount of any indebtedness secured by the contributed property exceeds the taxpayer's adjusted basis in such property at the time of contribution, IRC §357(c).

EXAMPLE: A and B each contribute a capital asset to a newly-formed corporation in exchange for 50 percent of the corporation's stock. Although neither of them owns 80 percent of the stock individually, all contemporaneous capital contributions are aggregated. Thus, neither A nor B will recognize the realized gain from the transaction because their transfers will be aggregated.

If a taxpayer enjoys non-recognition upon contribution, the basis of the shares received from the corporation is equal to the aggregate adjusted bases of the property transferred. IRC §358. Likewise, the corporation's basis in the contributed property is the same basis the contributing shareholder had in the property. IRC §362(a). If a taxpayer recognizes gain from the capital contribution, the taxpayer's basis in the acquired stock (and the corporation's basis in the contributed property) is generally its fair market value.

2. Operation

The C corporation is a separate taxable entity. It completes a Form 1120 to report its taxable income and, as of 2018, pays tax at a flat rate of 21 percent. IRC §11. C corporations may also be subject to additional "penalty taxes" where the corporate form is abused. These penalty taxes are discussed later in these materials.

3. Distributions

The signature feature of subchapter C is the double tax on corporate earnings. A corporate distribution will be included in the shareholder's gross income to the extent the distribution represents the "earnings and profits" of the corporation. IRC §§301(c)(1); 316(a). The distribution, however, will subject to a maximum tax rate of 23.8 percent. See IRC §§1(h)(11); 1411. Additional amounts in excess of the corporation's earnings and profits are presumed to be a return of the shareholder's contributed capital. IRC §301(c)(2). Consequently, the additional amounts received are tax-free to the extent of the shareholder's stock basis. If the shareholder's stock basis is used up and additional amounts still remain, the excess will be taxed as capital gain. IRC §301(c)(3). If the corporation distributes property, the shareholder takes a fair market value basis in the property. IRC §301(d).

If distributions of cash or property trigger the double tax, should distributions of the corporation's own stock also be taxable to the shareholder? In *Eisner v. Macomber*, 252 U.S. 189 (1920), the Supreme Court held that pro rata stock distributions were not taxable to the shareholders. Taxpayers then pushed the envelope: they created elaborate classes of stock that could be converted into cash or property or the corporation's common stock at the demand of a shareholder. The Service objected to these elaborate classes of stock as disguised dividend distributions, and some courts agreed. Congress has since cleared the air through a general rule proclaiming that stock distributions are tax-free. IRC §305(a). That general rule is subject to a

number of exceptions, see IRC §305(b), but most proportionate stock distributions remain tax-free. If a shareholder receives stock tax-free, the shareholder must allocate his or her basis in the old shares among the old and new shares. IRC §307(a).

4. Liquidation

"Liquidation" refers to the death or dissolution of the business entity. Under most state statutes, the assets of the entity are sold and the proceeds are used to pay off the entity's creditors. Any remaining proceeds are distributed proportionately to the owners. Instead of selling assets, liquidating entities may distribute assets to creditors and owners.

Unlike formation, liquidation is rarely painless from a tax perspective. Since a double tax has not been imposed on such assets (or, in the case of a sale, the proceeds), liquidating distributions to shareholders are taxable. IRC §331. Similarly, the corporation recognizes gain and loss upon a liquidating distribution. IRC §336. If a subsidiary corporation liquidates, there is a potential for a triple tax: once to the liquidating subsidiary, again to the parent corporation upon its liquidation, and finally to the shareholders of the parent corporation. To mitigate the adverse consequences attendant with these general rules, most subsidiary corporations may liquidate on a tax-free basis. IRC §332.

B. PLANNING OPPORTUNITIES WITH C CORPORATIONS

1. Reduced Rate on Gain from Sale of Qualified Small Business Stock

IRC §1202(a)(1) generally excludes half of the gain from the sale or exchange of qualified small business stock held for more than five years. The other half of such gain is subject to a preferential tax rate of 28 percent. IRC §§1(h)(1)(E); 1(h)(4); 1(h)(7). In effect, then, the entirety of such gain is taxed at a rate of 14 percent (half of the gain is taxed at 28 percent, half of the gain is not taxed at all).

Under the American Recovery and Reinvestment Act of 2009, the exclusion increased to 75 percent of the gain from the sale or exchange of qualified small business stock acquired after February 17, 2009, and before January 1, 2011. IRC §1202(a)(3). Where the special 75 percent exclusion applies, then, the effective rate of tax on the entire gain is only seven percent. The Creating Small Business Jobs Act of 2010, however, went one step further: qualified small business stock acquired from September 28, 2010, through December 31, 2010, was eligible for a 100-percent exclusion. The Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010 extended the 100-percent exclusion for stock acquired through 2012, and the American Taxpayer Relief Act of 2012 further extended the 100-percent exclusion to stock acquired in 2013. It was extended again through 2014 by the Tax Increase Prevention Act of 2014. Finally, the Consolidated Appropriations Act of 2016 made the 100-percent exclusion permanent for stock acquired after September 27, 2010. The following example clarifies the mechanics of the exclusion based on the acquisition date of the qualified small business stock:

EXAMPLE: T realized $100,000 of gain from the sale of qualified small business stock. T held the stock for more than five years. The amount T may exclude from gross income depends on when T *acquired* the stock, not the date of the sale. Specifically:

If the stock was acquired…	The portion of the $100,000 gain excluded is…
On or before Feb. 17, 2009	$50,000
After Feb. 17, 2009 but before Sep. 28, 2010	$75,000
After Sep. 27, 2010	$100,000

Only C corporation stock can claim this benefit. Specifically, "qualified small business stock" is any stock in a domestic C corporation originally issued after August 10, 1993, but only if such stock was acquired by the shareholder either as compensation for services provided to the corporation or in exchange for money or other non-stock property, and only if the corporation is a qualified small business. IRC §1202(c)(1). A "qualified small business" is one with aggregate gross assets of $50 million or less at all times after August 10, 1993, and before the time immediately after the date of issuance. IRC §1202(d)(1). "Aggregate gross assets" is measured as the sum of cash plus the adjusted bases of all corporate assets (assuming that the basis of all contributed property is equal to its fair market value as of the date of contribution). IRC §1202(d)(2).

In addition to these requirements, the corporation must meet an "active business requirement" during substantially all of the shareholder's holding period in order for IRC §1202 to apply. IRC §1202(c)(2)(A). This requires that at least 80 percent of the value of the corporation's assets be used in the active conduct of a trade or business engaged in any activity *other than*: (1) professional services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or other business in which the principal asset is the reputation or skill of one or more of its employees; (2) banking, insurance, financing, leasing, investing, or similar business; (3) farming; (4) extraction or production of natural resources eligible for percentage depletion; or (5) operation of hotels, motels, restaurants, or similar businesses. IRC §1202(e).

Depending on the applicable percentage exclusion (based on when the stock was acquired), the benefit of IRC §1202 exclusion may be significant. If IRC §1202 does not apply but the client holds the stock for more than one year, the gain will be long-term capital gain subject to a preferential tax rate generally ranging from zero to 23.8 percent. In case of IRC §1202 stock acquired before February 17, 2009, the cost of losing the 14 percent rate applicable to IRC §1202 stock may not be very significant. To the extent a client can save much more than this additional tax amount by making a subchapter S election or otherwise operating the business in a more profitable or tax-savvy manner that sacrifices the IRC §1202 exclusion, a planner should not be afraid to recommend such action. Of course, where the seven percent (or zero percent) preferential tax rate applies, the comparative benefit of IRC §1202 is stronger; depending on the amount of gain at issue, foregoing pass-through taxation or similar strategies might be desirable.

2. Like-Kind Exchange of Qualified Small Business Stock

One less heralded benefit of owning IRC §1202 stock is the ability to engage in a tax-deferred like-kind exchange under IRC §1045(a). As long as the selling shareholder purchases stock in another qualified small business within 60 days of the sale, he or she can elect to defer all non-recapture gain from the sale (provided the new stock costs at least as much as the amount realized from the sale of the old stock). The shareholder's basis in the new small business stock is reduced by the amount of gain deferred by the election. IRC §1045(b)(3).

EXAMPLE: T sells qualified small business stock in X Corporation with a basis of $13,000 to an unrelated buyer for $20,000. Within 60 days of this sale, T purchases qualified small business stock in Y Corporation from an unrelated seller for $20,000. T does not recognize any gain from the sale of the X Corporation shares but T's basis in the Y Corporation shares is $13,000 ($20,000 cost less $7,000 gain deferred from the sale of X Corporation stock). If T spends only $5,000 for the Y Corporation shares, T must recognize the $7,000 gain from the sale of X Corporation stock. T's basis in the Y Corporation shares would be $5,000.

3. Ever Thought of an S Election?

If the C corporation qualifies as a small business corporation under IRC §1361(b), its shareholders may elect S corporation status to ameliorate the impact of the double tax on C corporation earnings. IRC §1362(a). The S election usually causes no immediate tax consequences to the corporation or the shareholders (but see IRC §1363(d) and discussion *infra*), although built-in gains on assets held by the C corporation at the time of its conversion to an S corporation may have to be recognized by the S corporation. IRC §1374. This is better than a conversion from C corporation to partnership because that requires a deemed liquidation of the corporation, a taxable event to the corporation and the shareholders. IRC §§ 331(a); 336(a).

The S election may have other benefits beyond avoiding the double tax. If the C corporation is unable to use the cash method of accounting (under IRC §448(b), a C corporation generally cannot use the cash method unless: (1) it is engaged in farming; (2) substantially all of its activities consists of the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or (3) its average annual gross receipts for the three prior taxable years does not exceed $25 million), conversion to S corporation status will permit the entity to use the cash method unless the S corporation is a "tax shelter." IRC §448(a). A tax shelter is any "syndicate" within the meaning of IRC §1256(e)(3)(B) or a "tax shelter" as defined in IRC §6662(d)(2)(C)(iii) (yes, a "tax shelter" means "a syndicate or a tax shelter"). IRC §§448(d)(3); 461(i)(3).

If the C corporation is currently paying or may soon face liability for the personal holding company penalty tax in IRC §541, conversion to S corporation status will eliminate the penalty tax. IRC §1363(a).

COMMENT: A C corporation is a personal holding company if: (1) at least 60 percent of its "adjusted ordinary gross income" for the taxable year is "personal holding company income," and (2) at any time during the last half of the taxable year not more than five individuals own (directly or indirectly) more than 50 percent in value of the corporation's stock. IRC §542(a). Personal holding company income includes dividends, interest, royalties, annuities, rents, compensation for the use of corporate property by shareholders, and income from estates and trusts. IRC §543(a).

4. Other Chances to Minimize Double Taxation

Most C corporations can lessen the impact of the double tax by transferring earnings and profits into deductible payments of compensation, rent, or interest. While this is helpful to the corporation, it is generally worse for the shareholders in that these disguised distributions are ordinary income potentially subject to tax at rates far in excess of the preferential rate applicable to qualified dividend income. IRC §1(h)(11). One might expect that the competing interests of corporations and their shareholders might offset each other to the point that the Service might not care whether payments from corporations to shareholders are characterized as nondeductible (but tax-preferred) dividends or deductible (but fully taxable) forms of ordinary income. But in some cases these strategies are effective in reducing the total tax bite to corporation and shareholder.

EXAMPLE: A owns all of the stock in *Corp*, a C corporation. *Corp* has taxable income in Year One of $100,000. *Corp* will pay $21,000 in tax on this income (flat tax of 21 percent), leaving $79,000 of after-tax earnings. If *Corp* distributes the $79,000 as a dividend to A in Year Two, *Corp* gets no deduction, but A will pay tax of only $18,802 on the dividend (23.8 percent), leaving A with $60,198 after tax. If *Corp*'s taxable income in Year Two is also $100,000, it will again have $79,000 of after-tax earnings. So after two years, the combined after-tax income from Year One ($60,198) and Year Two ($79,000) is $139,198.

If *Corp* makes no distribution but pays A rent in the amount of $79,000 for Year Two, *Corp* would get a $79,000 deduction for Year Two but A would have to include this amount in gross income. Assuming A can deduct 20 percent of this amount under §199A as qualified business income, A will pay 37 percent tax on $63,200, or $23,384. After tax, then, A will have $55,616, a result worse for A than when the $79,000 is paid in the form of a dividend. But *Corp* gets to reduce its Year Two taxable income to $21,000, which in turn results in a tax liability of $4,410 (21 percent of $21,000). That leaves *Corp* will $95,590 after tax, meaning *Corp* comes out way ahead. The combined after-tax income from both years is $151,206 ($55,616 from Year One and $95,590 from Year Two), a better result than what is achieved with a dividend distribution.

Even if A cannot claim the §199A deduction, and thus pays $29,230 tax on the $79,000 of rents (37 percent), the combined after-tax result ($145,360) still beats the combined result of a dividend distribution of the same amount.

Making deductible payments in lieu of a distribution will not always result in less tax, however, as this next example shows.

EXAMPLE: Assume the same facts from the prior Example as regards Year One. Recall from that Example that after two years, the combined after-tax income from Year One ($60,198) and Year Two ($79,000) is $139,198.

If *Corp* makes no distribution but pays A a $79,000 salary in Year Two, *Corp* would get a $79,000 deduction for Year Two but A would have to pay tax of $35,273.50 on the compensation (assuming A is in the 37-percent bracket and pays A's share of employment taxes), leaving A with $43,726.50 after tax. This is a worse result for A than the dividend distribution (treating the amount received from *Corp* as compensation reduces the after-tax amount by over $16,000) but a better result for *Corp* (the compensation deduction reduces *Corp*'s taxable income to $21,000, which in turn results in a tax liability—$4,410—that is over $14,000 less than would otherwise result). Even when one factors in the employment taxes paid by *Corp* in Year Two (just over $6,000), *Corp* comes out ahead. But on these numbers notice that the combined after-tax income from both years ($133,273, which represents $43,726.50 from Year One and $89,546.50 from Year Two) is less than is the case when the corporation pays a dividend instead of salary.

The lesson here, then, is that one must run the numbers to determine whether a corporate deduction will offset the added tax hit to the shareholder. In some but not all cases, paying deductible rent, interest, or compensation will yield a better result than paying a dividend.

5. Redemptions to Pay "Death Taxes"

If the estate tax value of the decedent's stock in a corporation (C or S) comprises more than 35 percent of what we might call the decedent's "adjusted gross estate," IRC §303(a) treats the redemption of an estate's interest in a closely-held corporation as a sale of the stock (even if the transaction would otherwise be treated as a distribution with respect to the stock under IRC §302) to the extent the redemption proceeds do not exceed the sum of all estate, inheritance, legacy, and succession taxes imposed by reason of death plus funeral and administrative expenses deductible under IRC §2053. The redemption must occur within the estate tax return's assessment period to qualify for this benefit. IRC §303(b)(1).

The statute does not use the term "adjusted gross estate." It's just shorthand for the base used by IRC §303(b)(2), namely the value of the gross estate less the amounts deductible under IRC §§2053 (administrative expenses) and 2054 (casualty losses during administration).

C. PLANNING CHALLENGES WITH C CORPORATIONS

1. Penalties on Excessive Retained Earnings

Congress worries that the shareholders of a closely-held corporation prefer for the corporation to accumulate and retain its net earnings instead of paying dividends. Distributions of after-tax earnings are taxable to the shareholders. But if the corporation retains its after-tax earnings, the value of the corporation's stock increases without current taxation to the shareholders. The shareholders can thus defer the double tax on their shares of after-tax earnings until they either sell the stock (at an inflated price because of the retained surplus) or liquidate the corporation (at which point the retained earnings would finally be distributed). To thwart this deferral strategy, IRC §§531-537 impose an "accumulated earnings tax," a surtax levied on retained earnings in excess of the reasonable needs of the business where such retention has the purpose of avoiding income tax to the shareholders.

Prior to 2003, dividends were taxed at a higher rate than net capital gain. In those days, shareholders had even more incentive to keep after-tax earnings inside the corporation and then sell the stock at an inflated price because of the retained earnings. Absent the accumulated earnings tax, the shareholders could achieve tax alchemy by converting ordinary income into net capital gain. Now that most dividend distributions are taxed at the same rate as net capital gains, part of the incentive to avoid dividend distributions is lost. But the accumulated earnings tax remains. Sure, shareholders would still benefit from deferral of the double tax if the accumulated earnings tax did not exist, but deferral alone is hardly a grave sin.

A corporation's accumulated earnings tax is equal to 15 percent of its "accumulated taxable income." IRC §531. The accumulated taxable income figure roughly represents the corporation's undistributed taxable income (computed with some adjustments) in excess of amounts retained for the reasonable needs of the business. IRC §535(a). Note that the tax is imposed only with respect to the corporation's earnings in a single taxable year. Those earnings are not again subject to tax in later years as they continue to be retained.

Accumulations of $250,000 or less are deemed to be retained for the reasonable needs of the business (in the case of a personal service corporation, i.e., one engaged in any of the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, where the owners provide the services, the threshold is reduced to $150,000). IRC §535(c)(2). So if a corporation's retained earnings are within this threshold, there is no accumulated earnings tax exposure.

The tax is not self-assessed; rather it is a penalty imposed by the Internal Revenue Service. The Service initiates the issue by sending a notice to the corporation that all or part of a proposed notice of deficiency includes the accumulated earnings tax. At that point, the burden of proof shifts to the corporation to prove it is not liable for the tax. IRC §534.

In reviewing the financial statements for a client's corporation, the planner should consider whether the corporation is vulnerable to the accumulated earnings tax. Annual retained earnings in excess of the applicable threshold described above should be a red flag. If there is exposure, the planner should consider any of a number of possible solutions, including: (1) paying higher salaries to the owners in order to reduce retained earnings in a deductible way; (2) documenting the corporation's long-term capital-intensive plans that require accumulation of after-tax earnings; and (3) making a subchapter S election, if possible.

2. Funding the Buy-Sell Agreement

Shareholders of a closely-held C corporation may prefer that the corporation redeem the shares of a retiring or deceased shareholder (a "redemption agreement"), as opposed to having the surviving shareholders to purchase the shares directly (a "cross-purchase agreement"). Using entity funds to purchase the stock offers centralized funding (together with increased certainty of funding, for it is easier to monitor the reserves of the corporation than to continually police the saving habits of the other shareholders). In addition, where insurance will be used to fund the purchase, the C corporation needs fewer pre-tax dollars to fund premium payments to the extent the corporation is in a lower tax bracket than the shareholders.

But a redemption agreement carries some risks when the business operates as a C corporation. *First*, payments to the retiring shareholder may be treated as dividends, and while the preferential tax rate applicable to qualified dividend income helps it does not substitute for the lack of stock basis that could be used to reduce the tax bite. *Second*, to the extent there is net buildup in the value of life insurance contracts funding the C corporation's payment obligation, there is increased risk of alternative minimum tax. IRC §56(g)(4)(B)(ii). *Third*, if the C corporation uses a sinking fund or similar reserve to save up for a future redemption, there is additional risk that the Service will assert liability for accumulated earnings tax. While the corporation should be successful in proving that an accumulation of earnings to fund a redemption agreement is a reasonable business need, the corporation still faces the hassle of having to make this showing. *Finally*, corporate-owned life insurance is an asset of the corporation that, in turn, drives up the estate tax value of the corporation's stock when a shareholder dies. See Treas. Reg. §§20.2031-2(f); 20.2042-1(c)(6). Together these risks may not outweigh the benefits of centralized funding, but they should be factored in to the decision of whether to use a redemption agreement.

III. S CORPORATIONS

A. THE BASIC MECHANICS

1. Formation

Unless a specific provision in subchapter S applies, the rules applicable to C corporations also apply to S corporations. IRC §1371. Because subchapter S is silent as to incorporation issues,

the rules previously described for C corporations apply to S corporations. The only wrinkles upon formation of an S corporation pertain to the *eligibility* requirements to be an S corporation and the *timing* rules applicable to the subchapter S election.

a. Eligibility Rules

Not every corporation can elect to be treated as an S corporation. There are limits as to the number and types of shareholders that a corporation may have, although these limits are easily circumvented in most cases. There is also a limit as to the corporation's capital structure, a limit intended to ensure that the pass-thru of tax items remains relatively easy to administer.

As a threshold matter, **only domestic corporations** can elect to be treated as S corporations. IRC §1361(b)(1). A domestic corporation is any corporation organized in the United States or under the law of the United States or any particular state. IRC §7701(a)(4). A corporation organized in both the United States and a foreign country qualifies as a domestic corporation. Treas. Reg. §301.7701-5(a). See also PLR 9512001 (corporation organized in United States and in foreign country is eligible to make S election and will not be treated as having two classes of stock).

An S corporation can have **no more than 100 shareholders**. (From 1997 through 2004, there was a 75-shareholder limit.) With some exceptions, every person holding stock in an S corporation counts toward the 100-shareholder limitation. Rev. Rul. 59-187, 1959-1 C.B. 224. Spouses and their estates are treated as one shareholder for purposes of applying the limitation, IRC §1361(c)(1), regardless whether the spouses own shares jointly or separately or solely by operation of community property laws. Furthermore, all "members of a family" are treated as one shareholder for purposes of the 100-shareholder limitation. IRC §1361(c)(1)(A)(ii). Members of a family are the common ancestor, the lineal descendants of the common ancestor (up to a maximum of six (!) generations), and the current *and former* spouses of the lineal descendants or the common ancestor. IRC §1361(c)(1)(B). This effectively eviscerates the 100-shareholder limitation. (The determination of whether there is more than six generations separating the common ancestor from the youngest generation of shareholders is made on the latest of: (1) the date the S election is made; (2) the first date on which the common ancestor or a lineal descendant (or spouse) owns stock in the S corporation; and (3) October 22, 2004 (the date of enactment for the American Jobs Creation Act of 2004).)

Very generally, subchapter S welcomes most individual shareholders (and their estates, see IRC §1361(b)(1)(B)) but exhibits hostility toward entity shareholders. A discussion of **trusts as shareholders** of S corporation stock appears later in these materials.

COMMENT: There is no limitation as to how long an estate may hold S corporation stock. This is not the case for testamentary trusts, which, as discussed *infra*, must distribute S corporation stock or otherwise qualify as a permissible S corporation shareholder within two years.

Most individuals are eligible S corporation shareholders. In Revenue Ruling 2004-50, 2004-1 C.B. 977, the Service ruled that a federally recognized Indian tribal government is not an eligible S corporation shareholder, meaning that the corporation in which the tribe owns shares cannot make a subchapter S election. The Service noted that only individuals and certain estate and trusts can hold S corporation shares under IRC §1361(b)(1). Since the Indian tribe is exempt from taxation under established authorities, and because the tribe is not subject to federal income tax as an individual under IRC §1, the Service determined that the tribe was not an "individual" for purposes of qualifying the corporation for election to subchapter S status.

But a corporation cannot make an S election if it has a **nonresident alien** shareholder, IRC §1361(b)(1)(C), and if a nonresident alien individual becomes a shareholder in an S corporation, the corporation will lose its S election, IRC §1362(d)(2)(A), and will generally be precluded from re-electing S status for five years. IRC §1362(g). A nonresident alien individual is an individual that is neither a citizen of the United States nor a resident of the United States. IRC §7701(b)(1)(B).

An individual is a resident of the United States if he or she meets either the "green card test" or the "substantial presence test." Both of these tests are objective; the intent of the individual and other such subjective measures (like domicile) are irrelevant. An individual meets the green card test if he or she is a lawful permanent resident of the United States at any time during the calendar year. IRC §7701(b)(1)(A)(i). An individual meets the substantial presence test if he or she is present in the United States on at least 31 days of the current year and at least 183 total days of the current and two preceding calendar years. IRC §§7701(b)(1)(A)(ii); 7701(b)(3)(A). Presence, for these purposes, is determined using a composite, weighted measure of the days of physical presence over a three-year period. All days in the current calendar year are added to one-third of the days in the first preceding calendar year and to one-sixth of the days in the second preceding calendar year.

If a current S corporation (or a C corporation or a partnership whose owners wish to make an S election) wants to pass shares to a nonresident alien individual, the S corporation and the nonresident alien should form a partnership or other pass-thru entity for federal income tax purposes. This preserves the S election while permitting the nonresident to participate in the profits and losses of the enterprise. See Michael Schlesinger, S CORPORATIONS: TAX PLANNING AND ANALYSIS 12 (CCH 2000). Schlesinger notes that this structure would survive scrutiny under the partnership anti-abuse rules in Regulation §1.701-2 because the S corporation's shareholders are taxed on their shares of the S corporation's income while the nonresident alien is taxed on his or her share of the partnership's profits.

EXAMPLE: A and B each own 10 shares in an S Corporation. C, a nonresident alien individual, wants to join A and B as an equal stakeholder, and both of the existing owners want C involved in the business. To protect the corporation's S election, the corporation and C form a limited liability company to be taxed as a partnership for United States income tax purposes. The corporation contributes all of its business assets to the LLC in exchange for two-thirds of the membership interests in the LLC, while C makes proportionate contributions of cash and/or

property in exchange for a one-third interest in the LLC. The LLC's operating agreement provides that all tax items shall be allocated according to the membership interests, meaning the S corporation is taxed on two-thirds of the LLC's taxable income and that C is taxed on one-third of the LLC's taxable income. The share allocable to the S corporation passes through in equal shares to A and B. This structure should accomplish the objectives of A, B, and C without sacrificing the S election.

COMMENT: In the above example, if the LLC distributes some of the assets contributed by C to the S corporation (or if the LLC distributes some of the assets contributed by the S corporation to C) within seven years of their transfer to the LLC, the parties may have to recognize gain under the disguised sale rules in subchapter K. See IRC §§ 704(c)(1)(B); 707; 737.

Planners in community property states need to pay special attention to the nonresident alien prohibition. If an employee of an S corporation is married to a nonresident alien, the non-employee spouse may have a community property interest in any shares acquired by the employee as compensation. This would terminate the S election. Even if the shareholder-employee holds the S corporation shares as separate property, it may be possible for the non-employee spouse to acquire a community property interest in the shares to the extent the employee-shareholder otherwise receives inadequate compensation for the services he or she performs on behalf of the corporation. See William C. Staley, *S Corporations and Estate Planning*, at 6 (Glendale Estate Planning Council, Nov. 15, 2005).

Corporations, partnerships, limited liability companies, and other **business entities are not eligible to be shareholders** of S corporation stock. IRC §1361(b)(1)(B). Disregarded entities (such as single-member limited liability companies) are permissible shareholders if their owners are eligible S corporation shareholders. The Service will often ignore transitory ownership of S corporation stock by a partnership in the process of converting to an S corporation, even though there is no Code or regulation authority to forgive momentary ownership by an ineligible entity. See, e.g., PLRs 200237014, 200237011, 9010042, and 8934020.

Since 1998, organizations described in IRC §401(a) or IRC §501(c)(3) that are exempt from tax under IRC §501(a) can be S corporation shareholders. IRC §1361(c)(6). Translation? Employee stock ownership plans (ESOPs) and certain charitable organizations can hold S corporation stock. For eligible exempt organizations other than ESOPs, tax items from the S corporation pass through as unrelated business taxable income (UBTI). IRC §512(e).

An S corporation can only have **one class of stock**. IRC §1361(b)(1)(D). For this purpose, differences in voting rights among shares of common stock are disregarded. IRC §1361(c)(4). Estate planners like to see S corporations with voting and nonvoting shares, because nonvoting shares in a closely-held business make ideal assets for gifts and other wealth transfers from a discount planning perspective. An S corporation has a single class of stock if all shares have equal rights to distributions and liquidation proceeds. Treas. Reg. §1.1361-1(l)(1). Whether all shares

have equal economic rights is determined with reference to what the regulations call the corporation's "governing provisions." Treas. Reg. §1.1361-1(l)(2)(i). These include the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements related to distributions and liquidation.

b. Election

All shareholders must consent to make a subchapter S election. IRC §1362(a). An election is effective for the taxable year following the year of election, except that an election made in the first two and a half months of a taxable year is effective as of the first day of the taxable year. IRC §1362(b). The Service will grant relief for certain errors or omissions in connection with making an election. See §3.03 of Rev. Proc. 2022-19, 2022-41 I.R.B. 282. The nature of the relief depends on the error:

• *Election form missing the consent of a shareholder.* If the Form 2553 lacks the signature of one or more shareholders, there are several avenues for relief. First, Regulation §1.1362-6(b)(3)(iii) provides an extension of time for filing a shareholder consent. Second, the corporation may request relief for a late election using the simplified method in Revenue Procedure 2013-30. Third, Revenue Procedure 2004-35 offers automatic relief for taxpayers requesting relief for late consents for S elections in community property states. Finally, if none of these avenues for relief applies, the taxpayer may request relief through a private letter ruling.

• *Form 2553 lack officer's signature or uses wrong taxable year*. Where the Form 2553 lacks the signature of an authorized officer of the corporation that affects the validity of the election, or contains a mistake with respect to a permitted taxable year, the taxpayer can seek relief under Revenue Procedure 2013-30. But if that guidance does not apply, the taxpayer can seek correction through a private letter ruling request.

• *All other errors*. For all other errors in the election, the Service allows the taxpayer to explain the error and the necessary correction in writing submitted to the Service. The Service will not entertain ruling requests for these other errors.

2. Operation

In general, an S corporation will not pay income tax, since items of income, gain, loss, deduction, and credit pass through to the shareholders on a "per share" or "pro rata" basis. IRC §1366. Thus, if an S corporation has two equal shareholders, each must include one-half of the corporation's tax items on his or her own individual income tax return. The ultimate treatment of a tax item (as capital gain or ordinary income, for example) will depend upon the particular shareholder; consequently, some items pass through separately, while others are "netted" at the corporate level before passing through to the shareholders.

At the close of each taxable year, an S corporation shareholder's stock basis is adjusted to reflect both the shareholder's pro rata share of the S corporation's pass-through items and any distributions made during the year. IRC §1367(a). The adjustments to basis occur in this order (Treas. Reg. §1.1367-1(f)): (1) increase stock basis by the shareholder's share of income items; then (2) decrease stock basis by the amount of nontaxable distributions; then (3) decrease stock basis by the shareholder's share of noncapitalized, nondeductible expenses; then finally (4) decrease stock basis by the shareholder's share of loss and deduction items.

COMMENT: Examples of noncapital, nondeductible expenses include illegal bribes, fines, penalties, expenses related to tax-exempt income, disallowed losses under IRC §267, and the disallowed portion of meal and entertainment expenses under IRC §274.

3. Distributions

The tax treatment of distributions from S corporations depends upon whether the S corporation has accumulated earnings and profits. Only C corporations can have "earnings and profits." IRC §312. Corporations that have always been S corporations do not have accumulated earnings and profits.

Distributions from "pure" S corporations (those that have never been C corporations) are tax-free to the extent of the shareholder's stock basis. IRC §1368(b)(1). Any distributions in excess of a shareholder's basis is treated as gain from the sale or exchange of property (i.e., as long-term capital gain if the stock has been held for more than one year, or short-term capital gain if the stock has been held for one year or less). IRC §1368(b)(2). Whether a shareholder has sufficient stock basis to absorb a distribution is tested at the end of the year, after all items of income and other increases to basis occur, but before any reductions to stock basis due to losses, deductions, and nondeductible expenses. Treas. Reg. §1.1367-1(f). This ordering rule maximizes the chances that any particular distribution will be tax-free. If an S corporation distributes appreciated property instead of cash, the distribution triggers gain to the corporation. IRC §§1371(a); 311(b). Like any gain, it passes through pro rata to the shareholders, with resulting increases to stock basis.

If an S corporation has accumulated earnings and profits, the distribution rules are slightly more complicated. A three-tier regime applies to such distributions. *First*, that portion of the distribution not in excess of the corporation's "accumulated adjustments account" ("AAA") is taxed under the rules applicable to distributions from S corporations without earnings and profits (i.e., tax-free to the extent of stock basis, with any excess treated as capital gain). IRC §1368(c)(1). If an S corporation makes more than one distribution during the taxable year, and if the total amount of such distributions exceeds the positive balance in the corporation's AAA, the AAA is allocated proportionately to all of the distributions. Treas. Reg. §1.1368-2(b).

Second, the remainder of the distribution is treated as a dividend to the extent of the corporation's accumulated earnings and profits. IRC §1368(c)(2).

Third, if the distribution exceeds accumulated earnings and profits, the balance is treated under the rules applicable to distributions from S corporations without earnings and profits. IRC §1368(c)(3).

The AAA is an entity-level account that begins at zero when the corporation's S election takes effect. Treas. Reg. §1.1368-2(a)(1). It is then adjusted upward and downward, generally by the same items that adjust a shareholder's basis under IRC §1367. IRC §1368(e)(1)(A); Treas. Reg. §§1.1368-2(a)(2), -2(a)(3). There are some differences, however, between the adjustments to the AAA and the adjustments to stock basis. For one thing, the AAA can go below zero. IRC §1368(e)(1)(A). And, importantly, no adjustment is made to the AAA for tax-exempt income or for expenses related to tax-exempt income. Thus, for example, death benefits received by an S corporation generally do not affect AAA even though the corporation has an increase in cash because the death benefits are excluded from gross income under IRC §101(a). Likewise, premium payments on life insurance policies should not affect AAA if the corporation will receive the death benefits on a tax-free basis.

Also, taxes paid by the corporation for years attributable to the corporation's period as a C corporation can adjust stock basis but such amounts do not affect the AAA. As these exceptions suggest, AAA is generally a reflection of the S corporation's items of income and deduction of tax consequence that have been passed through to the shareholders (in other words, perhaps, the corporation's previously taxed income).

Redemptions carry out a ratable share of the corporation's AAA if the redemption is treated as a sale or exchange under either IRC §302(a) or IRC §303(a). Treas. Reg. §1.1368-2(d)(1)(i). If the corporation makes both regular distributions and redemption distributions in the same taxable year, the AAA is adjusted first for ordinary distributions and then for any redemption distributions. Treas. Reg. §1.1368-2(d)(1)(ii).

Shareholders seeking to avoid the complexity of IRC §1368(c) may consider distributing the entire amount of the corporation's accumulated earnings and profits. This "purging" distribution permits future distributions to be tested under the simpler regime of IRC §1368(b). There are two ways to make a purging distribution. First, the corporation can elect to treat any distributions as coming first from accumulated earnings and profits and then from the AAA. Treas. Reg. §§1.1368-1(f)(1)(i); 1.1368-1(f)(2)(i). In effect, this election swaps the first two tiers of the three-tier regime. The practical effect of this election is that distributions are includible as dividends to the extent of earning and profits and *then* tax-free to the extent of stock basis. If one expects the preferential rates for qualified dividend income to expire in the near future, the election might be beneficial to the distributee-shareholders in the long term. At the same time, the election can be beneficial to the other shareholders.

The second way to make a purging distribution is for the corporation to elect a deemed dividend distribution. Under this approach, the corporation makes no actual distributions but the

shareholders are taxed as though the corporation made a pro rata distribution of its accumulated earnings and profits at a time when its AAA is zero, followed by the shareholders' contribution of those same dollars back to the corporation, all on the last day of the taxable year. Treas. Reg. §§1.1368-1(f)(1)(ii); 1.1368-1(f)(3). This alternative keeps capital within the corporation's hands but may leave the shareholders without the dollars required to pay the tax associated with the deemed dividend.

4. Liquidation

The rules applicable to C corporation liquidations apply to S corporation liquidations. Thus, the corporation realizes gain and loss upon the distribution of assets to shareholders, and such gains and losses pass through to the shareholders like other income and deduction items. These gains and losses affect a shareholder's stock basis like other pass-through items.

B. PLANNING OPPORTUNITIES WITH S CORPORATIONS

1. Leverage the Purchase of Additional Shares

Normally, interest paid on debt incurred to purchase investment property ("investment interest") is deductible by the borrower only to the extent of his or her "net investment income." IRC §163(d)(1). This limitation does not apply to interest paid on debt incurred to purchase stock in an S corporation or a partnership. Instead, such interest is deemed to be paid on debt incurred to purchase the pass-through entity's inside assets. Reg. §1.163-8T. Accordingly, if all of the entity's assets are used in the conduct of a trade or business, the interest paid on debt incurred to buy stock in the S corporation or partnership will be considered business interest. That's good news because business interest is not subject to the same limitation applicable to investment interest (in other words, business interest is deductible without regard to the currently taxable income generated by the entity's business). IRC §§163(a); 163(h)(2)(A). So if the client is thinking about purchasing additional shares (or if the client wants to help another to purchase the client's shares in the S corporation), this benefit is worth keeping in mind when running the numbers.

2. The Employment Tax Loophole for Sole-Shareholder S Corporations

While all of the operating profits of a disregarded single-member LLC or sole proprietorship are subject to employment taxes, only the salary paid to the sole shareholder of an S corporation is considered "wages" subject to employment taxes. Rev. Rul. 73-361, 1971-2 C.B. 331. Operating income of an S corporation not distributed in the form of salary is not self-employment income. Rev. Rul. 59-221, 1959-1 C.B. 225. See also IRS Publication 533. As a result, sole shareholders of S corporations have an incentive to receive no salary from their S corporations and take all of their incomes in the form of distributions.

Of course, if an S corporation pays no salary to its sole shareholder-employee, the Service may recharacterize some portion of the corporation's distributions as wages for employment tax

purposes. Rev. Rul. 74-44, 1974-1 C.B. 287. There are many cases in which the Service has been successful in converting a portion of S corporation distributions into wages for purposes of employment taxes. See, e.g., *Mike J. Graham Trucking, Inc. v. Commissioner,* T.C. Memo 2003-49, affd in unpublished opinion (3d Cir. 2004); *Veterinary Surgical Consultants v. Commissioner*, 117 T.C. 141 (2001), affd in unpublished opinion (3d Cir. 2004). The taxpayers in both *Graham Trucking* and *VSC* argued that distributions from S corporations could not be treated as compensation because §530 of the Revenue Act of 1978 states that employment taxes do not apply if the S corporation has never treated the shareholder-employee as an employee for any period and if all filed returns are consistent with this assumption. The taxpayers conveniently forgot the language in §530 that says that employment tax relief does not apply if the corporation "had no reasonable basis for not treating such individual as an employee." The courts in both cases held that there was no precedent for treating the shareholder-employees as contractors or non-employees within their respective industries, and there were no audits of the corporations that upheld such treatment by the corporations. Accordingly, there was no basis for the corporations not to treat the taxpayers as employees, so some portion of the corporations' distributions must be treated as wages. See James A. Fellows and John F. Jewell, *S Corporations and Salary Payments to Shareholders: A Major Issue for the IRS*, 2006 The CPA J. 46 (May 2006) (available at http://www.nysscpa.org/cpajournal/2006/506/essentials/p46.html).

Still, it appears the Service is not exercising its recharacterization power as much as it could: nearly a decade ago, a report of the Treasury Inspector General for Tax Administration claimed that some 36,000 sole shareholder-employees received no salaries from their S corporations. Statement of J. Russell George, Inspector General, Treasury Inspector General for Tax Administration before the Senate Finance Committee (May 25, 2005), available at http://www.treas.gov/tigta/congress/congress_05252005. htm. See also Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05) (2005) at 426 (estimating that treating all net income from partnerships and S corporations as self-employment income could increase revenues by $57.4 billion over the nine-year period from 2006 to 2014); Tony Nitti, *S Corporation Shareholder Compensation: How Much is Enough?*, AICPA The Tax Adviser (August 1, 2011). The same report indicated that the percentage of S corporation profits paid to their sole shareholder-employees dropped from 47.1 percent in 1994 to 41.5 percent in 2001. To the extent sole proprietors and owners of disregarded entities have 100 percent of the business profits subject to employment taxes, there remains an advantage to keeping salaries modest and maximizing distributions from an S corporation.

The question becomes how much salary to pay to the sole shareholder-employee of an S corporation. The cautious approach is for the S corporation to pay its shareholder-employee the same salary that he or she would require if the shareholder-employee were only an employee of the entity. See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41st Annual Southern Federal Tax Institute Materials at J-3 (2006). More aggressive clients may prefer the lemming approach: keep salaries to about 41 – 47 percent of the S corporation's net profits so as to be consistent with other S corporations, even if a non-shareholder-employee would insist upon a higher salary from the corporation.

3. Shift Built-in Gains to Your Low-Bracket (or Idiot) Co-Owners

When a shareholder contributes property with a value in excess of its adjusted basis to an S corporation, the corporation generally takes the contributing shareholder's basis in the property. IRC §362(a). When the S corporation subsequently sells the appreciated property, the gain from the sale, like any gain, is apportioned proportionately among the shareholders. The built-in gain is not allocated automatically to the contributing shareholder, which is not the case for a partnership. IRC §704(c)(1)(A). See discussion *infra* on partnerships. This provides contributing partners with an opportunity to shift gain to other, lower-bracket taxpayers without having to worry about the assignment of income doctrine.

EXAMPLE: *A* and *B* form an S corporation when *A* contributes inventory worth $100,000 (in which *A*'s basis is $10,000) and *B* contributes $100,000 cash. *A* and *B* are given equal shares in the corporation's single class of stock. If the corporation sells the inventory for $100,000 to an unrelated party, the corporation's $90,000 gain (ordinary income if the property is inventory in the hands of the corporation) will be allocated equally among *A* and *B*. Notice that $45,000 of the gain attributable to the period during which *A* held Blackacre is effectively shifted to *B*. If *B* is related to *A* and is in a lower tax bracket than *A*, this could be a beneficial result. Of course, *B* may not see it that way, so an "opportunity" for *A* is a "challenge" for *B*.

4. Manufacturing Basis to Claim Net Losses

An S corporation shareholder may deduct his or her proportionate share of the corporation's losses to the extent of the shareholder's stock basis and any basis in debt owed by the corporation to the shareholder. IRC §1366(d)(1). Losses in excess of these basis limitations are carried forward to subsequent taxable years, IRC §1366(d)(2), but time value of money considerations suggest we should do what we can to give the shareholder enough basis in the year the loss passes through to the shareholder.

If a client's share of an S corporation loss exceeds the client's stock basis and debt basis, the planner should explore techniques to give the client sufficient basis to claim the loss currently. A simple solution is for the client to make a loan or capital contribution to the S corporation, but the client may not have the dollars immediately available or may want to get basis now but pay later. It is not enough for the client to contribute a promise to pay to the corporation; there is no basis credit for the client's own note until actual payments are made on the note. But if the corporation has another shareholder, the client could consider giving a note to the other shareholder in exchange for some or all of the other shareholder's stock. Paying for stock with a note gives the client immediate stock basis that can be used to claim the loss flowing from the S corporation, while deferring the actual out-of-pocket cost to the client. See Jeanne E. Sullivan, *Structure and Techniques for S Corporations for 2007 and Beyond*, 31ST ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION, Outline 11 (2007) at 61.

C. PLANNING CHALLENGES WITH S CORPORATIONS

1. Beware the Interests Given to Employees

If an employee of an S corporation owns more than two percent of the corporation's outstanding stock (or more than two percent of the total combined voting power of the corporation's stock) on any day of the taxable year, the employee is no longer eligible to receive "employee fringe benefits" on a tax-free basis. IRC §1372(a); Reg. §1.707-1(c). If the majority shareholder seeks to reward key employees with stock, it might have the unintended consequence of forfeiting some of these important benefits.

To be more precise, IRC §1372(a) states that so-called "2-percent shareholders" of an S corporation are to be treated as partners in a partnership for purposes of applying Code provisions related to employee fringe benefits. Regulation §1.707-1(c) treats fringe benefits paid to employee-partners as "guaranteed payments" because they are paid without regard to the partnership's income for services rendered. The same regulation states that a partner who receives guaranteed payments is not, by virtue of the payments, regarded as an employee of the partnership. Accordingly, the value of a fringe benefit "is not excludible from the partner's gross income under the general fringe benefit rules (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners) because the benefit is treated as a distributive share of partnership income … for purposes of all Code sections other than sections 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income." Rev. Rul. 91-26, 1991-1 C.B. 184. See also Albert B. Ellentuck, *S Corporation's Treatment of Employee-Shareholder Fringe Benefits*, THE TAX ADVISER (May 2003).

Examples of benefits not excludable by so-called "2-percent shareholders" are: (1) the cost of accident and health insurance plans under IRC §§105 and 106; (2) meals and lodging furnished on the business premises for the convenience of the employer under IRC §119; (3) the cost of group-term life insurance coverage under IRC § 79; and (4) cafeteria plans under IRC §125. When a 2-percent shareholder receives one of these taxable fringe benefits, it is to be treated as additional compensation subject to Federal withholding and employment taxes. Rev. Rul. 91-26, 1991-1 C.B. 184. That means the S corporation likely gets a deduction for the extra compensation, and this deduction will pass through to the shareholders *pro rata* like any other deduction item.

Not all fringe benefits excluded from the gross incomes of employees are lost; benefits that remain excludable include: (1) dependent care assistance under IRC §129 (IRC §129(e)(3) provides that the exclusion is available to self-employed individuals as well as employees; because partners in a partnership and 2-percent shareholders in an S corporation are deemed to be self-employed, as discussed *supra*, the exclusion is available to partners and 2-percent shareholders in an S corporation); (2) educational assistance programs under IRC §127, IRC §127(c)(2); and (3) several of the fringe benefits listed in IRC §132, including no-additional-cost

services, qualified employee discounts, de minimis fringes, working condition fringes, and on-premises athletic facilities. Reg. §§1.132-1(b)(1); 1.132-1(b)(2)(ii); 1.132-1(b)(3); 1.132-1(b)(4).

2. Getting Basis Credit for Entity Debt

As mentioned above, S corporation shareholders need basis (either stock basis or debt basis) in order to claim their shares of the corporation's net losses. While partners in a partnership are entitled to basis credit for their shares of the partnership's debts, the same is not true for shareholders of an S corporation. It is not sufficient for a shareholder to guarantee the S corporation's debt in order to give the shareholder basis credit for the debt. (If the shareholder makes an actual payment on the guarantee, he or she gets basis credit for the amount paid.)

The preferred approach is for the lender to make the loan to the shareholder who then loans those proceeds to the S corporation. By structuring the loan arrangement in this fashion, the shareholder makes a loan to the corporation, which expressly entitles the shareholder to basis credit. In fact, as long as proper formalities are observed and the shareholder in fact assumes liability for servicing the debt, the refinancing of an entity debt into a shareholder debt can give the shareholder debt basis. See *Miller v. Commissioner*, T.C. Memo. 2006-125 (restructuring of corporation's line of credit under which shareholder assumed the debt gave shareholder basis credit to the extent of the shareholder's liability). As the *Miller* court observed, "The same result as a 'back to back' loan is reached where a shareholder substitutes his own note for the note of his S corporation on which he was a guarantor, thereby becoming the sole obligor on the new indebtedness. In such 'note substitution' scenarios, so long as the S corporation's indebtedness to the third-party lender is extinguished, so that the shareholder becomes the sole obligor to the lender, the shareholder's assumption of what was formerly the S corporation's legal burden serves as a constructive furnishing of funds to the S corporation for which the S corporation becomes indebted to repay to the shareholder."

It is worth noting that to the extent the shareholder incurs personal liability in order to have the loan structured in such a way as to give the shareholder basis credit for the debt, the shareholder bears a genuine risk that a direct loan to the corporation would not present. But since many loan arrangements with closely-held S corporations require personal guarantees from the shareholders already, structuring the loan to pass through the shareholder may not affect the shareholder's liability for repayment.

3. Debt as a Second Class of Stock

Speaking of debt, planners have to tread carefully here. Shareholder loans to an S corporation may be recharacterized as equity, which would give the S corporation an impermissible second class of stock. A loan to an S corporation will be treated as stock if the transaction constitutes equity under general principles of federal tax law or if the principal purpose of the transaction is to circumvent the single-class-of-stock or eligible-shareholder rules. Treas. Reg. §1.1361-1(l)(4)(ii)(A). To be safe, all loan arrangements from shareholders to S

corporations should come within one of the three safe harbors outlined in the regulations: (1) short-term unwritten advances that never exceed $10,000 in the aggregate (Treas. Reg. §1.1361-1(l)(4)(ii)(B)(1)); (2) debts owed solely to the shareholders and in proportion to their stock holdings (Treas. Reg. §1.1361-1(l)(4)(ii)(B)(2)); and (3) "straight debt." Straight debt is a written, unconditional obligation to pay a sum certain (on demand or on a specified due date) held by a United States citizen or resident, an estate, or an eligible trust shareholder and which does not provide for contingent interest (that is, interest computed or payable that is contingent on corporate profits, the borrower's discretion, the payment of dividends, or similar factors) and is not convertible to into stock. Treas. Reg. §1.1361-1(l)(5)(i).

The debt-as-second-class-of-stock problem can arise in situations planners may not expect. For example, if an S corporation redeems a portion of the shares of a retiring or deceased shareholder, the applicable buy-sell agreement usually permits the S corporation to pay the purchase price in installments. If the buy-sell agreement requires the S corporation to pay interest on the deferred payments, the obligation may create a second class of stock unless it qualifies under straight debt safe harbor. Planners should review the provisions of a buy-sell agreement involving S corporation stock to make sure this situation does not arise by accident.

4. The Perils of Former C Corporations

If an S corporation used to be a C corporation, the planner has to proceed carefully. Three separate Code provisions come into play for former C corporations, although the last two are more significant because they continue to haunt the former C corporation for quite a while following the subchapter S election.

The first provision is IRC §1363(d), which forces a corporation using the LIFO method of inventory valuation to recapture as gross income the excess of the FIFO value of its inventory over the LIFO value of its inventory at the close of the corporation's last taxable year as a C corporation. The recapture amount is treated as gross income in such last taxable year, but the increase in tax caused by this recapture is payable in four equal annual installments without interest. Unless the planner is helping the business to elect S corporation status, the planner will likely not have to address this issue.

The second provision is IRC §1374, proof that the S election does not provide a perfect conduit for former C corporations. This provision imposes a tax on the disposition of "built-in gains." It is the S corporation that is liable for payment of this tax. The basic theme behind the IRC §1374 tax on built-in gains is that gains and losses attributable to taxable years prior to the S election should be taxed as though the corporation were still subject to subchapter C.

EXAMPLE: *X* Corporation purchased raw land for $100 three years ago. Today, the land is worth $500, and the corporation wants to sell the land to an unrelated purchaser. If *X* sells the land, *X* will be taxed on the $400 gain. If *X* then distributes the after-tax proceeds of the sale to its shareholders (as a dividend), the after-tax profit will be taxed again. The shareholders of *X*

thus have an incentive to make the S election prior to the sale. If *X* makes an S election prior to the sale, the $400 gain will pass to the shareholders under IRC §1366, and subsequent distribution of the proceeds will be tax-free under IRC §1368. In effect, the election allows *X* to convert two levels of tax into one level of tax.

Congress reacted to this situation by enacting IRC §1374. Now, when the gain occurs during years in which the corporation was subject to two layers of tax, it is appropriate to tax that gain twice even though the entity is currently a valid S corporation.

The IRC §1374 tax applies to any "net recognized built-in gains" during each of the first several years following the former C corporation's subchapter S election (known as the "recognition period"). Legislation in 2009 shortened the recognition period to seven years for 2009 and 2010 only. IRC §1374(d)(7)(B). Under the Creating Small Business Jobs Act of 2010, the recognition period for taxable years beginning in 2011 only was shortened to five years, and the American Taxpayer Relief Act of 2012 extended the five-year recognition period through 2013. The Tax Increase Prevention Act of 2014 extended the five-year recognition period through 2014. Finally, the Consolidated Appropriations Act of 2016 made the five-year recognition period permanent.

The tax is computed by applying the highest rate under IRC §11 (now 21 percent) to the net recognized built-in gain for the taxable year or, if less, the corporation's taxable income for the taxable year. IRC §§1374(b)(1); 1374(d)(2)(A). The cumulative amount of net recognized built-in gains during the recognition period cannot exceed the corporation's "net unrealized built-in gain" as of the date of the S election. IRC §1374(c)(2). Note that the tax applies to any disposition that results in a recognized built-in gain, whether in the form of a sale or a distribution to the shareholders. IRC §§311(b); 1374(d)(3).

The tax imposed under IRC §1374 passes through to the S corporation's shareholders as a loss with the same character as the corresponding gain giving rise to the tax. IRC §1366(f)(2). This lessens the impact of the double tax to some extent.

There are several ways to avoid or lessen the burden of the IRC §1374 tax. Perhaps the most common solution is to wait out the recognition period: the tax does not apply to dispositions of built-in gain property that occur after the recognition period expires. The tax can be deferred if the corporation effects a like-kind exchange of the built-in gain property under IRC §1031, although the IRC §1374 taint is preserved in the asset(s) received in the like-kind exchange. IRC §1374(d)(6). Regulations provide that if an S corporation acquires some asset before or during the recognition period with a principal purpose of reducing or eliminating the IRC §1374 tax (because the asset will generate a loss, deduction, or credit that can be used to reduce the corporation's taxable income below the amount of net recognized built-in gain), such loss, deduction or credit shall be ignored for purposes of computing the IRC §1374 tax. Treas. Reg. §1.1374-9. Finally, one could consider a charitable contribution of the built-in gain property. The S corporation does not recognize gain upon making the gift to charity (so the IRC §1374 tax

cannot apply), and the deduction flows through to the shareholders. The shareholders reduce their stock bases by their shares of the corporation's adjusted basis in the contributed property, which insures that the lurking gain is not later taxed upon sale of the shares or liquidation of the corporation. IRC §1367(a). First introduced in 2006, this rule expired four times before being made permanent by the Protecting Americans from Tax Hikes Act of 2015.

The third provision is IRC §1375, which imposes a penalty tax at the entity level when two conditions exist: (1) an S corporation has "accumulated earnings and profits" (which by definition only applies if the S corporation was formerly a C corporation), and (2) the S corporation's "passive investment income" exceeds 25 percent of its total gross receipts. If the IRC §1375 tax is imposed for three consecutive years, the corporation will face the "death penalty": its S election is terminated and the corporation will revert to C corporation status. IRC §1362(d)(3).

Why the concern with the amount of passive income generated by a corporation? One treatise explains the policy of these rules as follows:

> These statutory measures restrict attempts to use S corporations as incorporated pocketbooks for their shareholders by investing the corporations' retained earnings in marketable securities and other passive investments of a type that the shareholders would have purchased had the earnings been paid out as dividends. This ploy is particularly likely to happen when the C corporation has liquidated its business assets. The passive-investment-income limitation can also be viewed as a rough-and-ready offset to the fact that a C corporation can be converted to S status without subjecting its accumulated earnings to tax at the shareholder level as if the earnings were distributed in a quasi-liquidation.

Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (7th student ed. 2000) at 6-19. Basically, Congress wants to limit the benefits of subchapter S to corporations engaged in active businesses.

The mechanics of the IRC §1375 tax are relatively simple. The corporation's "excess net passive income" is multiplied by the highest rate of tax under IRC §11 (21 percent). IRC §1375(a). Excess net passive income is computed under this formula:

$$\frac{\textbf{(PII)} - \textbf{(25\% of GR)}}{\textbf{(PII)}} \times \textbf{(NPI)} = \textbf{Excess Net Passive Income}$$

PII = **passive investment income** (royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of securities). See IRC §§1362(d)(3)(C)(i); 1375(b)(3).
GR = **gross receipts** (the total amount received or accrued under the corporation's accounting method). See Treas. Reg. §1.1362-2(c)(4)(i).

NPI = **net passive income** (passive investment income less those deduction directly connected with the production of passive investment income other than net operating loss carryovers and dividends-received deductions). See IRC §1375(b)(2).

The corporate-level taxes are coordinated because built-in gains and losses are taken out of the definition of passive investment income. IRC §1375(b)(4). Instead of passing through as a loss, the amount of IRC §1375 tax serves to reduce the amount of each item of passive investment income passing through to the shareholders. IRC §1366(f)(3).

There are some planning suggestions for minimizing exposure to the IRC §1375 tax. If the corporation had relatively little earnings and profits at the time of the S election, it may be advisable to distribute the subchapter C earnings and profits to the shareholders, especially since those earnings will be taxed at preferential tax rates to the shareholders in the hopes of avoiding a 21 percent tax imposed on the corporation. IRC §1368(e)(3) permits the shareholders to declare that distributions come first from subchapter C earnings and profits and then from subchapter S earnings (the accumulated adjustments account), although the default distribution rules apply the opposite assumption. Once the subchapter C earnings and profits are gone, the IRC §1375 tax (and the risk of the death penalty under IRC §1362(d)(3)) cannot apply. Alternatively, the shareholders can try their very best to manage gross receipts so that the amount of passive income does not cross the 25 percent threshold.

5. Beware Trusts Holding S Corporation Stock

Only certain domestic trusts qualify as S corporation shareholders. If S corporation falls into the hands of an "ineligible" shareholder, the S election is lost and the corporation becomes a C corporation unable to elect S corporation status for five years unless it successfully obtains discretionary relief from an inadvertent termination of the S election. Although many trusts qualify as eligible shareholders of S corporation stock, some common trust arrangements do not qualify. For instance, a charitable remainder trust is not an eligible shareholder of S corporation stock. Planners should therefore not advise clients to fund charitable remainder trusts with S corporation stock because doing so would sacrifice the S election.

Generally there are five kinds of trusts that qualify as S corporation shareholders.

The first is the **qualified subchapter S trust**, or QSST. IRC §1361(d). Among other things, a QSST must be a domestic trust. See IRC §§7701(a)(30)(E); 7701(a)(31)(B). Under these rules, a trust is a domestic trust only if: (a) a court within the United States has primary supervision over the administration of the trust, and (b) one or more United States fiduciaries control all substantial decisions of the trust. The regulations give some examples of the "substantial decisions" related to a trust that a fiduciary may have. Treas. Reg. §301.7701-7(d)(1)(ii). These include, among others: (1) whether and when to make distributions of income and principal; (2) the amount of distributions; (3) whether a receipt is allocated to income or principal; (4) the

selection of a beneficiary; and (5) whether to appoint a successor trustee to succeed another trustee that is unable or willing to serve or continue to serve.

Further, the QSST may have only one income beneficiary during that beneficiary's life (unless each beneficiary has a separate share of the trust, see IRC §663(c)) who is a United States citizen or resident. Spouses are treated as one current income beneficiary if they file jointly and each is a United States citizen or resident. The trust instrument must require that all income be distributed currently (or such income must in fact be paid at least annually to the current income beneficiary). A QSST may permit distributions of principal only to the current income beneficiary during his or her life. No one else may be entitled to distributions of income or principal during the trust term, and no payments can be made from the trust that discharge someone else's obligation to support the current income beneficiary. The trust instrument must provide that the current income beneficiary's income interest terminates at his or her death or, if earlier, upon expiration of a fixed term. If a QSST terminates during the current income beneficiary's life, all assets must be distributed to him or her.

To become a QSST, the current income beneficiary must make a QSST election. If the corporation loses its S election solely because the current income beneficiary of an otherwise valid QSST fails to make a QSST election, the S election may be preserved if a QSST election is filed within two years of its original due date. See Rev. Proc. 2003-43, 2003-1 C.B. 998.

In the case of a trust owning shares in a C corporation that becomes an S corporation, the QSST election is made on Part III of the Form 2553, Election by a Small Business Corporation. If the corporation's S election is already in effect when the trust receives the shares, the QSST election is made by signing and filing a statement with the service center where the corporation files its income tax return. Treas. Reg. §1.1361-1(j)(6)(ii). The statement must: contain the name, address, and taxpayer identification number of the current income beneficiary, the trust, and the corporation; identify the election as one made under IRC §1361(d)(2); specify the date on which the election is to become effective (cannot be more than 2 months and 15 days before the date the election is filed); specify the date(s) on which stock was transferred to the trust; and provide all information required to prove that the trust meets the requirements of a QSST.

The current income beneficiary reports all S corporation items attributable to the stock held by the QSST on his or her personal tax return. If the trust sells the S corporation stock, gain or loss is recognized by the trust (although the sale is considered to have been made by the current income beneficiary for purposes of the at-risk rules in IRC §465 and the passive loss rules in IRC §469). See IRC §1361(d)(1)(C).

For purposes of the 100-shareholder limitation, the current income beneficiary is treated as the shareholder of the stock. IRC §1361(c)(2)(B)(i).

The second is the **electing small business trust**, or ESBT. See IRC §1361(e). A trust can qualify as an ESBT if it has only individuals, estates, and/or qualified exempt organizations (any

organization described in IRC §170(c)(2) – (5) is a qualified exempt organization, as is any IRC §170(c)(1) organization that holds a contingent interest and is not a potential current beneficiary) as present, remainder, or reversionary beneficiaries. A person who may take under the exercise of a power of appointment is not considered a beneficiary of the trust for this purpose unless such power is actually exercised in that person's favor.

A trust cannot qualify as an ESBT if any person has acquired an interest in the trust by purchase. A purchase includes any transaction in which the basis of the acquired property is its cost. IRC §1361(e)(1)(C). In addition, each "potential current beneficiary" of the trust must be an eligible shareholder of S corporation stock if the trust is to qualify as an ESBT. A potential current beneficiary is one entitled to (or who may currently) receive distributions of income or principal from the trust. IRC §1361(e)(2). The trust cannot be a charitable remainder trust or otherwise exempt from federal income tax.

An eligible trust becomes an ESBT when the trustee(s) with authority to legally bind the trust sign and file an election statement with the service center where the corporation files its income tax return. Treas. Reg. §1.1361-1(m)(2)(i). The statement must include: the name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the corporation; a statement that an ESBT election pursuant to IRC §1361(e)(3) is being made; the date when the trust first owned stock in the corporation; the date the election is to take effect (cannot be more than 2 months and 15 days before the date the election is filed); and representations that the trust meets all of the requirements of an ESBT and that all potential current beneficiaries are eligible shareholders of S corporation stock.

While the requirements for an ESBT are easier to meet than the requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself must pay a flat tax equal to the highest rate applicable to trusts and estates under IRC §1(e) (currently 37 percent) on the trust's taxable income attributable to the S corporation items, the exemption amount for alternative minimum tax purposes is reduced to zero, and no capital loss carryovers are permitted. IRC §641(c). The trust continues to pay tax at the slightly progressive rates of IRC §1(e) on income attributable to other assets.

For purposes of the 100-shareholder limitation, each potential current beneficiary is counted as a shareholder. IRC §1361(c)(2)(B)(v). During any period that there is no potential current beneficiary of an ESBT, the trust itself is treated as the shareholder for purposes of applying the 100-shareholder limitation.

In computing an ESBT's income attributable to the S corporation, the only items taken into account are: (1) the trust's shares of the S corporation's item of income, gain, loss, deduction, and credit; (2) gain or loss from the trust's sale of the S corporation stock; (3) state or local income taxes and administrative expenses allocable to the S corporation stock; and (4) interest paid or accrued on debt used to acquire stock in the S corporation. IRC §641(c)(2)(C).

The third kind of trust eligible to be an S corporation shareholder is a good, old-fashioned **grantor trust**. IRC §1361(c)(2)(A)(i). A grantor trust is any trust that is deemed to be owned by the grantor or another person under any of IRC §§671-678. For more on the use of grantor trusts in estate planning, see (ahem) Samuel A. Donaldson, *Understanding Grantor Trusts*, *in* 40 HECKERLING INSTITUTE ON ESTATE PLANNING 2-1 (Tina Portuando ed., 2006).

A grantor trust is effectively disregarded for federal income tax purposes because all of the trust's tax items are reported by the deemed owner. Accordingly, if the deemed owner is an eligible shareholder of S corporation stock, transfers of S corporation stock to a grantor trust will not jeopardize the company's S election. For purposes of the 100-shareholder limitation, the deemed owner is counted as the shareholder. IRC §1361(c)(2)(B)(i). This is true even where the trust contains *Crummey* powers that give the beneficiaries a power to withdraw some or all of the amounts contributed to the trust so that a gift of S corporation stock to the trust qualifies for the federal gift tax annual exclusion. See, e.g., PLR 200732010 (grantor trust with *Crummey* powers is an eligible shareholder of S corporation stock because the grantor's ownership of the trust under IRC §674 trumped the beneficiaries' ownership of the trust under IRC §678(a).

The fourth kind of eligible trust is a **former grantor trust**. IRC §1361(c)(2)(A)(ii). As its name implies, a former grantor trust is a trust that was a grantor trust (with a United States citizen or resident as the deemed owner) immediately before the deemed owner's death and that continues after such death. Although the trust is no longer a grantor trust because of the deemed owner's demise, the trust itself remains an eligible S corporation shareholder regardless of its dispositive scheme until the day before the second anniversary of the deemed owners death. After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. The estate of the deemed owner is counted as the shareholder for purposes of the 100-shareholder limitation. If no one is the deemed owner of the trust, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock.

The final kind of eligible trust is a **testamentary trust**. All testamentary trusts are permitted S corporation shareholders for a two-year period beginning on the date the stock is transferred to the trust. IRC §1361(c)(2)(A)(iii). After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. During the two-year grace period, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock if no one is the deemed owner of the trust. The testator is treated as the shareholder for purposes of applying the 100-shareholder limitation.

IV. PARTNERSHIPS

A. THE BASIC MECHANICS

1. Formation

Like a corporation, formation of a partnership is also a painless event. A partner will not recognize gain or loss upon a transfer to the partnership in exchange for an interest unless the contribution consists of services. IRC §721. Note that a partner does not need to be an 80-percent owner to achieve non-recognition, as does the shareholder of a corporation. To preserve any gain or loss not recognized, the partner's basis in the partnership interest equals the sum of the bases of the properties transferred to the partnership in exchange for the interest. IRC §722. The partnership also takes a carry-over basis in the property received from the partner. IRC §723.

2. Operation

The tax items of a partnership pass through to the partners. IRC §§701; 702. Unlike an S corporation, however, the partners of a partnership are generally free to allocate these tax items among the partners as they wish, so long as these allocations have "substantial economic effect." IRC §704(b). Thus, equal partners in a partnership may agree to allocate all losses to one partner and all tax-exempt income to the other partner, so long as the allocations have "substantial economic effect." The flexible tax allocations make the partnership a more attractive business vehicle to most business owners.

Allocations have "economic effect" if the partnership agreement requires, for the full term of the partnership, that: (1) capital accounts be created and maintained in the manner set forth in the regulations (see Treas. Reg. §1.704-1(b)(2)(iv)); (2) liquidating distributions be made in accordance with the partners' positive capital account balances; and (3) any partner with a deficit balance in his or her capital account following liquidation of the partnership be unconditionally obligated to restore the amount of the deficit (see Treas. Reg. §1.704-1(b)(2)(ii)(b)). A partner's capital account balance is the amount he or she would be entitled to receive upon liquidation of the partnership. A capital account is increased by the net value of any contributed cash or property and the partner's share of partnership income items. It is decreased by the value of any distributions to the partner and the partner's share of partnership loss and deduction items

If the partnership agreement complies with the first two requirements but does not comply with the third requirement, the allocation can still have economic effect under an alternate test. See Treas. Reg. §1.704-1(b)(2)(ii)(d). Assuming the economic effect test is met, an allocation will be respected if it is **substantial**. While various standards for substantiality are provided in the regulations—a general rule as well as a rule for shifting and transitory allocations—the focus is whether the allocation will affect substantially the dollar amounts to be received by the partners from the partnership. See Treas. Reg. §1.704-1(b)(2)(iii).

3. Distributions

As you would expect, distributions from a partnership are generally tax-free since the partners have already taken the partnership's tax items into account on their own income tax returns. No gain is recognized upon a distribution to a partner except to the extent the amount of cash distributed exceeds the partner's outside basis immediately before the distribution. IRC §731(a)(1). No gain or loss is recognized by the partnership. IRC §731(b). If a partner receives cash or property regardless of the partnership's profitability, however, the distribution may constitute a "guaranteed payment" that will be treated as compensation income. IRC §707. Further discussion of the partnership distribution rules appears later in these materials.

4. Liquidation

The basis of property (other than money) distributed to a partner in liquidation of the partner's interest in the partnership is an amount equal to the partner's basis in the partnership interest reduced by any money distributed in the same transaction. IRC §732(b). Liquidation of a partner's interest is defined as the termination of the partner's entire interest in the partnership by means of a distribution or series of distributions. See IRC §761(d). Loss is not recognized by a partner upon a distribution *except* that loss *is* recognized on a distribution in liquidation of a partner's interest where no property other than cash, unrealized receivables, and inventory items are received by the partner. IRC §731(a)(2). The amount of the loss (which is considered to be loss from the sale or exchange of the partnership interest) is equal to the excess of the partner's basis in the partnership interest over the sum of the cash distributed to the partner and the adjusted basis of the distributed property under IRC §732.

B. PLANNING OPPORTUNITIES WITH PARTNERSHIPS

1. The IRC §754 Election and the Adjustment to Inside Basis

If the partnership makes an election under IRC §754, the partnership's basis in its assets ("inside basis") will be adjusted, but only with respect to the transferee partner. Specifically, the entity will increase its inside basis by the excess of the transferee partner's outside basis (freshly stepped-up under IRC §1014, remember) over his or her share of the partnership's inside basis. Alternatively, if the transferee partner's outside basis was stepped-*down* under IRC §1014, the entity will reduce its inside basis by the excess of the transferee partner's share of inside basis over his or her outside basis. This adjustment to inside basis affects not just the allocation of gain and loss to the transferee partner upon a disposition of a partnership asset. It determines the partner's share of inside basis for purposes of depreciation deductions and distributions, as well.

Notice that if the estate planner succeeds in claiming a significant valuation discount for the value of the partnership interest included in the deceased partner's gross estate, there is an

adverse effect on the adjustment to inside basis (though usually not to such an extent that the valuation discounts have no net value).

EXAMPLE: Mom dies holding a five percent general partner interest and a 20 percent limited partner interest in a partnership. The partnership's assets have a combined liquidation value of $1,000,000 and an aggregate inside basis of $200,000. Mom's estate values the five percent general partner interest at $40,000 (assuming a 20 percent blended valuation discount against the $50,000 liquidation value attributable to the general partner interest) and it values the 20 percent limited partner interest at $120,000 (assuming a 40 percent blended valuation discount against the $200,000 liquidation value attributable to the limited partner interest). Both interests pass to Son. Son's aggregate outside basis is $160,000, the sum of the date-of-death values of the general and limited partner interests included in Mom's gross estate.

If the partnership has a valid IRC §754 election in effect, the $50,000 of aggregate inside basis (that portion of the inside basis attributable to Mom's interests) is increased to $160,000, *not* to its $250,000 liquidation value. Thus, while the IRC §754 election eliminates the disparity between inside and outside bases with respect to Son, the election does not completely eliminate the inherent gain attributable to the interests now held by Son; if the partnership sells all of its assets, $90,000 of gain will be allocable to Son. Of course, this beats the $200,000 gain that would have been allocable to Son had no IRC §754 election been made. And the estate tax savings from an aggregate $90,000 discount likely exceeds the income tax burden from $90,000 of extra gain. But it shows that the higher the discount, the less beneficial the IRC §754 election becomes to the decedent's successor in interest.

Note that if the deceased partner's surviving spouse is also a partner in the partnership, and if the spouses owned their interests as community property, the surviving spouse's interest in the partnership also triggers an adjustment to inside basis if the IRC §754 election is in effect.

2. S Corporation Election

Unincorporated domestic entities (like partnerships) can elect to be treated as corporations for federal tax purposes. Treas. Reg. §301.7701-3. Any such organization that elects status as a corporation can also elect to be taxed as an S corporation. See, e.g., Priv. Ltr. Rul. 199942017. To the extent a partnership wants to avail itself of the benefits of S corporation status, the partners can simply make this two-step election to achieve the desired status.

The key obstacle, of course, is that an electing unincorporated entity must meet the eligibility requirements of an S corporation in order for the S election to become effective. The entity, for example, cannot have more than 100 owners and no owner may be a nonresident alien individual. See IRC §1361(b)(1)(A), (b)(1)(C). These are easy enough to spot, but the "single-class-of-stock" requirement for S corporations under IRC §1361(b)(1)(D) can be harder to police. The Service will not issue rulings as to whether a limited partnership qualifies as a small business corporation eligible to elect S corporation status. Rev. Proc. 2011-3, 2011-1 I.R.B. 111, §5.11. No

doubt this is because the varying rights and obligations of general and limited partners may well constitute a second class of stock. See Rev. Proc. 99-51, 1999-2 C.B. 760. We know that a limited partnership agreement does not create a second class of stock as long as distributions to the partners are to be made in accordance with the partners' respective cumulative interests. See, e.g., Priv. Ltr. Ruls. 200326023, 200326024, and 200326025. In the last of these private rulings, the shareholders of an S corporation (S1) formed a limited liability partnership (LLP) that made a double-election to be treated as an S corporation. The shareholders then contributed their S1 stock to LLP and S1 elected to be treated as a qualified subchapter S subsidiary corporation (or "Q-Sub"). LLP then created a wholly-owned limited liability company (LLC) that is disregarded for federal tax purposes as an unincorporated organization with only one owner. LLP transferred some of its S1 stock to LLC. Because LLC is disregarded, S1's Q-Sub election is not lost. S1 then converted to a limited partnership, with LLC as the general partner and LLP as the limited partner. As a limited partnership, S1 made a triple-election (electing to be a corporation, an S corporation, and a Q-Sub). At the end of the day, then, the shareholders owned all of the interests in LLP (an S corporation for tax purposes) which in turn held all of the limited partner interests (and, through a disregarded entity, all of the general partner interests) in a limited partnership (a Q-Sub for tax purposes). The Service approved this transaction in the ruling.

If the partnership agreement requires distributions in accordance with positive capital account balances and such capital accounts are not in proportion to the partners' percentage interests, however, the partnership likely has more than one class of stock, making the S election unavailable. See Richard B. Robinson, *Tax Audit Issues for S Corporations*, in 41ST ANNUAL SOUTHERN FEDERAL TAX INSTITUTE MATERIALS at J-7 (2006). Disproportionate operating distributions from the partnership should not create a second class of stock provided the entity makes corrective distributions to make distributions proportionate. See, e.g., Priv. Ltr. Rul. 200524020.

3. Allocating Items in the Year of a Partner's Death

Upon the death of a partner, IRC §706(c)(2)(A) provides that the taxable year of the partnership closes with respect to the deceased partner. The deceased partner's final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a *pro rata* allocation based on the number of days in each period. Treas. Reg. § 1.706-1(c)(2)(ii).

EXAMPLE: *A*, *B*, and *C* are equal general and limited partners in a partnership. *A* dies on July 1, Year One. The partnership's income for Year One consists of two gains: a $900 gain in March and a $300 gain in November. If the partnership makes an election to close its books on July 1, the proportionate shares of the partners would be as follows:

Partner	March Gain Share	November Gain Share
A	$300	zero
B	$300	$150
C	$300	$150

If, on the other hand, the partnership does not close its books, the proportionate shares of the partners for Year One would be as follows:

Partner	March Gain Share	November Gain Share
A	$150	$50
B	$375	$125
C	$375	$125

In this example, *B* and *C* are inclined to close the books, for their proportionate shares under a closing of the books ($450) is less than their shares if no such election is made ($500). Of course, if the November gain were larger than the March gain, the incentive would be the opposite.

The point is that the fiduciary and the surviving partners should work together to determine which approach is better. The same is generally true of S corporations. IRC §1377(a), presumes that S corporation items will be allocated *pro rata* on a daily basis unless the surviving shareholders agree to an interim closing of the books.

C. PLANNING CHALLENGES PRESENTED BY PARTNERSHIPS

1. The Estate Planning Drawbacks of Special Allocations

Partners are generally free to allocate the income, gain, loss, deduction, and credit items of the partnership among themselves however they may agree, subject to the constraint in IRC §704(b) that such allocations have "substantial economic effect." Detailed regulations give guidance for ensuring that allocations meet this amorphous standard. The regulations provide two safe harbors under which an allocation will be deemed to have "economic effect." Treas. Reg. § 1.704-1(b)(2)(ii). The first safe harbor applies where the partnership agreement requires: (1) the determination and maintenance of capital accounts in accordance with specific rules provided elsewhere in the regulations; (2) that liquidating distributions be made in accordance with the positive capital account balances of the partners; and (3) that any partner with a deficit balance in his or her capital account at liquidation be required to restore the deficit balance to the partnership within a stated period. Treas. Reg. § 1.704-1(b)(2)(ii)(b). The second safe harbor applies where the partnership agreement requires: (1) both of the first two conditions of the first safe harbor (maintenance of capital accounts according to specific rules and liquidating distributions according to positive capital account balances); (2) the operation of a "qualified income offset" provision; and (3) that no allocation to a partner may cause or increase a deficit balance to that partner's capital account in an amount greater than the amount that partner is obligated to restore upon liquidation of the entity. Treas. Reg. § 1.704-1(b)(2)(ii)(d).

Both safe harbors require the partnership to maintain capital accounts using specific accounting rules set forth in the regulations. Treas. Reg. § 1.704-1(b)(2)(iv). In some cases, compliance with these accounting rules proves to be difficult (i.e., expensive).

Special allocations of partnership income and deduction items are common in partnerships that conduct an active trade or business in which the partners participate. From an estate planning perspective, however, they may pose two problems. First, the use of special allocations might run afoul of IRC §2701. Section 2701 values certain retained interests in a partnership at zero for purposes of valuing subordinate equity interests transferred to certain family members. If all interests in a partnership have identical distribution and liquidation rights, IRC §2701 does not apply. Accordingly, estate planners usually advise the partners to make sure all income and deduction allocations are made according to the partners' interests in the partnership, regardless of whether such interests have voting or management rights. Differences in voting and management rights (as well as differences in liability for entity debts) do not by themselves create subordinate equity interests, so creating voting and nonvoting partnership interests does not trigger application of IRC §2701's zero-value rule. Treas. Reg. § 25.2701-1(c)(3).

Second, where the planner intends to have a partner give some portion of his or her partnership interest to a donee, the planner must be cognizant of IRC §704(e)(2). It states that where there has been a gift of a limited partner interest in a partnership, the recipient's distributive share of the partnership's income is limited in two ways. *First*, the donor must be adequately compensated for any services rendered to the FLP. In other words, the donor cannot perform services at no charge for the partnership and pass along the savings to the recipient. For example, suppose Parent gives Child a 40 percent limited partner interest in a partnership, retaining a ten percent general partner interest and a 50 percent limited partner interest. The partnership's taxable income for the year is $100,000. In that same year, Parent performed services for the partnership valued at $40,000. An allocation of $40,000 of the $100,000 taxable income to Child would violate IRC §704(e)(2) because it does not consider the services performed by Parent. Instead, the $40,000 in services should be treated as compensation to Parent, leaving $60,000 to be allocated according to the partners' interests in the partnership. In sum, Parent would be allocated income totaling $76,000 ($40,000 for Parent's services plus 60 percent of the partnership's remaining $60,000 income, or $36,000), while Child would be allocated $24,000 of income (40 percent of the partnership's $60,000 income after services).

Second, if the recipient's interest was funded with donated capital, the donor and the recipient must be allocated income in proportion to the donated capital. In effect, the maximum income allocable to a recipient partner is the income allocable to the recipient partner's interest in partnership capital. Thus, if Mom and Dad form a partnership with contributed capital and gift a 20 percent limited partner interest to Child, Child must report 20 percent of the partnership's income attributable to the contributed capital. Combining the two rules under IRC §704(e)(2), the regulations state that family partnership income must be distributed proportionate to capital interests after distributing reasonable compensation to the donor for services rendered to the partnership. Treas. Reg. § 1.704-1(e)(3).

If the partnership is a holding company (one not actively conducting a trade or business), it is rare to see special income or deduction allocations. Given the risks described above, it might

be better *not* to follow the capital account rules in the regulations, provided the partnership agreement requires all allocations to be in accordance with the partners' interests in the partnership. Remember: failure to fall within one of the two safe harbors for economic effect means only that the Service can reallocate items if it determines that an allocation with not made in accordance with the partners' interests in the partnership. It does not mean that all allocations are *per se* invalid.

2. Distributions within Seven Years of Capital Contributions

Normally, property distributions from a partnership are tax-free. IRC §731(a). Cash distributions from a partnership are taxable to the extent the cash distributed exceeds the recipient partner's basis in the partnership interest immediately prior to the distribution. IRC §731(a)(1). But if the partnership liquidates within seven years of a partner's contribution of property to the partnership, two Code provisions can convert a tax-free liquidation into a taxable one. For more on the federal income tax aspects of liquidating a partnership formed for estate planning purposes, see Samuel A. Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 CAP. U. L. REV. 15 (2006). Look, *someone* has to cite my works.

First, IRC §704(c)(1)(B) provides that if property distributed to one partner was contributed to the partnership by another partner within seven years of the distribution, and if that property had built-in gain or loss at the time of contribution, then the contributing partner must recognize the built-in gain or loss at the time of the distribution.

EXAMPLE: *A* and *B* formed a partnership in Year One when *A* contributed farmland worth $500,000 and with an adjusted basis of $300,000 in exchange for a five percent general partner interest and a 45 percent limited partner interest, and *B* contributed cash in the amount of $500,000 for a 50 percent limited partner interest. In Year Five, the partnership distributed the farmland to *B*. Assuming the value of the land has not changed since contribution, *A* must recognize *A*'s $200,000 built-in gain from the farmland in Year Five.

Recognition of the built-in gain is avoided if the property is distributed back to the contributing partner. For this purpose, any assignee or successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain allocable to the assignee-successor's interest. Treas. Reg. § 1.704-4(d)(2).

EXAMPLE: Assume the same facts from the prior example, If in Year Four *A* gave *A*'s general and limited partner interest to *C*, and if in Year Five the partnership distributed the farmland to *C*, neither *A* nor *C* recognizes gain from this distribution under IRC §704(c)(1)(B) since *C* was *A*'s successor in interest.

Second, IRC §737 generally provides that if a partner contributes appreciated property to the partnership and, within seven years of such contribution, receives a distribution of non-cash property, the contributing partner must recognize the IRC §704(c) built-in gain (or, if less, the excess of the distributed property's value over the partner's outside basis immediately prior to the distribution minus any cash received in the same distribution).

EXAMPLE: Assume the facts from the example involving *A* and *B* and the formation of their partnership in Year One. The partnership used the cash contributed by *B* to acquire a small parcel of vacant land in the suburbs. In Year Five, the partnership distributed the suburban land to *A*. Assuming the value of the contributed properties has not changed since contribution, *A* must recognize the $200,000 built-in gain from the farmland in Year Five.

As was the case with IRC §704(c)(1)(B), an assignee-successor to a contributing partner's interest is treated as a contributing partner for purposes of IRC §737's general rule. Treas. Reg. § 1.737-1(c)(2)(iii).

EXAMPLE: Assume the same facts from the prior example. If *A* gifted *A*'s general and limited partner interests to *C* in Year Four and the partnership distributed the suburban land to *C* in Year Five, *C* "steps into *A*'s shoes" and must recognize in Year Five the $200,000 built-in gain from *A*'s contribution of the farmland in Year One.

On its face, § 737 would apply if the contributing partner received back from the partnership the appreciated property originally contributed to the partnership. Regulations recognize that because such a "return-to-sender" distribution is not taxable under IRC §704(c)(1)(B), IRC §737 does not apply if the contributing partner receives the property he or she originally contributed to the partnership. Treas. Reg. § 1.737-2(d)(1). Oddly, however, there is no rule providing that an assignee-successor to the contributing partner's interest likewise qualifies for this exception. It is therefore possible that an assignee-successor must recognize gain under IRC §737 upon receipt of property originally contributed to the partnership by the assignee-successor's predecessor in interest—even though the receipt of the contributed property by the same party is expressly *not* subject to IRC §704(c)(1)(B). For a contrary view, *see* Ellen K. Harrison and Brian M. Blum, *Another View: Responding to Richard Robinson's 'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313, 315 (2003).

The moral of the story here is to postpone any distributions of IRC §704(c) property until the partnership has held such property for seven years, as IRC §§704(c)(1)(B) and 737 only apply to distributions made within seven years of contribution.

3. Distributions of Marketable Securities Treated as Cash Distributions

Under IRC §731(a)(1), no gain is generally recognized upon a distribution from a partnership except to the extent that any cash received in the distribution exceeds the recipient partner's outside basis immediately prior to the distribution. For purposes of this rule, however, IRC §731(c) provides that marketable securities are treated as cash (valued at fair market value as of the date of distribution). That, of course, creates the risk that a distribution of marketable securities will be a taxable event to the recipient partner.

EXAMPLE: *A* and *B* formed a partnership when *A* contributed a collectible with a value of $100,000 and a basis of $20,000 and *B* contributed $100,000 cash. The partnership used $50,000 of the cash to purchase Microsoft stock. The partnership then distributed the Microsoft stock to *A*. Under IRC §731(c), the stock distribution is treated as a cash distribution in the amount of $50,000, the value of the Microsoft shares distributed. *A* recognizes gain of $30,000 because the amount of deemed cash distributed exceeds *A*'s $20,000 outside basis.

By its terms, IRC §731(c) does not apply if: (a) the marketable securities received by the partner were those contributed by the same partner; (b) subject to some limitations, the marketable securities distributed were acquired by the partnership in a nonrecognition transaction (provided the total cash and marketable securities acquired by the partnership in the nonrecognition transaction is less than 20 percent of the value of the assets transferred by the partnership in such transaction and further provided that the distribution of the marketable securities occurs within five years of the partnership's acquisition of the securities (or, if later, within five years of the date when the securities became marketable)); (c) the distributed securities were not marketable when first acquired by the partnership and did not become marketable for at least six months (the partnership must distribute the securities within five years of the date upon which they became marketable and the issuer of the securities must not have issued any marketable securities prior to the time the partnership first acquired the distributed securities); or (d) the partnership is an "investment partnership" and is making a distribution to an "eligible partner."

This last exception requires elaboration. A partnership will qualify as an investment partnership if it has never been engaged in a trade or business and 90 percent or more of its assets, measured by value, have always consisted of portfolio assets. Treas. Reg. § 1.731-2(c)(3)(i). And an eligible partner is any partner that contributed nothing but such portfolio assets to the partnership. Treas. Reg. § 1.731-2(e)(2)(i).

Now let's return to the first exception: marketable securities will not be treated as cash for purposes of IRC §731 if they are distributed to the same partner that contributed them to the partnership. This is consistent with the "return-to-sender" exceptions under IRC §§704(c)(1)(B) and 737 described above. But here, as with IRC §737, there is no rule extending the exception to a distribution of marketable securities to an assignee-successor to the contributing partner's partnership interest. Regulation § 1.731-2(d)(1) states, in relevant part that "section 731(c) and

this section do not apply to the distribution of a marketable security if-(i) the security was contributed to the partnership by the distributee partner….” No mention is made of a successor in interest here.

In short, then, those who receive a partnership interest by gift may have to recognize gain upon a distribution of marketable securities from the partnership even if those securities were contributed to the partnership by the donor. And the application of this rule does not expire after seven years.

One solution is to effect a proportionate distribution of any marketable securities. By doing so, one makes better use of the limitation in IRC §731(c)(3)(B), which reduces the amount of the deemed cash distribution by the recipient partner's share of gain on the distributed securities.

EXAMPLE: In Year One, *A*, *B*, and *C* formed a partnership when *A* contributed stock in Starbucks Corporation worth $900,000 (in which *A* had a basis of $720,000) in exchange for a four percent general partner interest and an 86 percent limited partner interest, while *B* and *C* contributed their undivided, one-half interests in a parcel of raw land worth a total of $100,000 (in which each had a basis of $20,000) in exchange for a ten percent limited partner interest (five percent held by *B* and five percent held by *C*. *A* died in Year Ten, leaving *A*'s general and limited partner interests in equal shares to *B* and *C*. At the date of *A*'s death, the Starbucks stock is worth $1.5 million, and the raw land is worth $500,000. *A*'s estate claims a 50 percent combined discount on the value of the partnership interests passing to *B* and *C*, reporting a combined value of $900,000 on *A*'s federal estate tax return (90 percent interest in a total liquidation value of $2 million, less 50 percent). Each beneficiary's aggregate outside basis in FLP is now $470,000 ($450,000 attributable to the 90 percent interest from *A* that was stepped-up under IRC §1014 plus $20,000 attributable to the ten percent interest acquired through their contribution).

If the partnership distributes the Starbucks stock in equal shares to *B* and *C*, each is deemed to receive a cash distribution of only $360,000 (not $750,000), because the $390,000 gain that would be allocated to each child from partnership's sale of the stock reduces the deemed cash distribution pursuant to IRC §731(c)(3)(B). (For convenience, this example assumes no IRC §754 election is in place.) This deemed distribution is not taxable to either *B* or *C* because each has an outside basis in excess of the deemed distribution amount. The distribution will reduce each of *B*'s and *C*'s outside basis to $110,000 ($470,000 minus $360,000 deemed cash). Note that IRC §704(c)(1)(B) does not apply in this example because the distribution occurs after the seven-year period during which IRC §704(c)(1)(B) is alive.

If, instead, the partnership distributes the raw land plus $500,000 of the Starbucks stock to *B* ($1 million total) and the remaining $1 million of Starbucks stock to *C*, the result changes. *C* is deemed to receive a cash distribution of $610,000 (not $1 million), because the $390,000 gain that would be allocated to *C* from the partnership's sale of the stock reduced the deemed cash distribution under IRC §731(c)(3)(B). Because *C*'s outside basis immediately prior to the distribution is

$470,000, *C* must recognize $140,000 of gain thanks to the deemed cash distribution. The disproportionate distribution of the Starbucks stock to *C* in this case forced the recognition of gain that would not have occurred in a proportionate distribution of the stock. Notice here that the IRC §754 election might be detrimental to the successors in interest. An increase in inside basis lessens the benefit of the IRC §731(c)(3)(B) reduction for the distributee's distributive share of gain on the property. If the partnership would realize no gain if it sold the distributed property, there is no reduction in the amount of the deemed cash distribution. Thus, while the IRC §754 election is generally beneficial in the context of IRC §§704(c)(1)(B) and 737, it can be disadvantageous for purposes of IRC §731(c).

The IRC §731(c)(3)(B) gain limitation is handy where the partnership distributes marketable securities with a low inside basis. Partners should therefore be reluctant to distribute freshly-purchased marketable securities with an inside basis (nearly) equal to their value. Likewise, marketable securities that have recently declined in value are less attractive candidates for distribution to donee-partners.

While a proportionate distribution of marketable securities may be helpful in avoiding IRC §731(c), it presents problems outside of the tax realm. Beneficiaries are often reluctant to hold assets as tenants in common (proof that the minority interest discount and, to a greater extent, the marketability discount are quite real). If so, then perhaps the best solution to the IRC §731(c) problem lies back in the exceptions: where possible, a partnership holding a substantial amount of marketable securities should own only portfolio assets at all times and care should be taken to make sure each partner is an "eligible partner." One *bad* solution would be to reallocate the partnership's gain to the distribute partner in an effort to maximize use of the IRC §731(c)(3)(B) gain limitation. Regulations give the Service the power to disregard a blatant attempt to avoid IRC §731(c)(1) through a change in partnership allocations. Treas. Reg. § 1.731-2(h)(1).

4. Sales of Partnership Interests Can Yield Ordinary Income

Subchapter K uses a hybrid aggregate-entity approach for the sale of an interest in a partnership. Generally, the sale gives rise to capital gain or loss because the selling partner is disposing of a capital asset. IRC §741. But the portion of the gain or loss allocable to "unrealized receivables" or "inventory items" will be treated as ordinary income or loss. IRC §751(a). This rule applies no matter whether the partner sells all or part of the partner's interest.

Unrealized receivables are any rights to payments for goods or services that have not previously been included in the partnership's gross income. The term also includes any gain attributable to assets the sale of which would give rise to ordinary income. IRC §751(c). **Inventory items** are any assets that are neither capital assets nor IRC §1231 assets. IRC §751(d). Accordingly, "inventory" means not only inventory but also, for example, supplies used in the partnership's business and gains from hedging transactions.

EXAMPLE: *A* owns a one-third interest in the *ABC* Partnership, a cash method partnership that develops real estate. *ABC* both constructs buildings for sale to customers and holds real estate for rental purposes. On January 1, *A* sells her partnership interest to *D* for $180,000 cash. *ABC*'s balance sheet at the time of the sale is as follows:

Asset	Basis	Value	Capital	Basis	Value
Cash	$ 45,000	$ 45,000	*A*	$110,000	$180,000
Accounts Receivable	$ 0	$ 60,000	*B*	$110,000	$180,000
Building for sale	$150,000	$180,000	*C*	$110,000	$180,000
Building for rent	$135,000	$240,000			
Goodwill	$ 0	$ 15,000			
	$330,000	$540,000		$330,000	$540,000

A's realized gain from the sale is $70,000. To determine the character of this gain, we must pretend *ABC* sold *A*'s share of all partnership assets for fair market value. Treas. Reg. §1.751-1(a)(2). The accounts receivable are "unrealized receivables" under IRC §751(c), and *A*'s share of the $60,000 partnership gain from a sale of the receivables is $20,000. In addition, the building held for sale is an inventory item of the partnership under IRC §751(d), and *A*'s share of the $30,000 gain to the partnership is $10,000. Accordingly, *A* must recognize $30,000 of ordinary income from the sale of her partnership interest ($20,000 from the receivables and $10,000 from the building for sale). The building held for rent is not IRC §751(a) property because it is not held for sale to customers. The property qualifies as IRC §1231 property under IRC §1231(b), so it is not an "inventory item" of the partnership. The remaining $40,000 of *A*'s $70,000 realized gain may be long-term capital gain, provided *A* held her partnership interest for more than one year.

5. No Tax-Free Mergers with Corporations

Only corporations can participate in tax-free reorganizations with other corporations. A merger between a partnership and a corporation is treated as a taxable exchange. If the partners anticipate selling their business to a corporation and wish to participate in a tax-free reorganization transaction, they may be tempted to "check the box" so that the partnership is taxed as a corporation. But if the partners make the election only shortly before engaging in the reorganization, there is a high risk that the transaction will not qualify for nonrecognition. This risk arises under the common law step transaction doctrine, where a proposed reorganization planned prior to the formation of a target corporation can be deemed a taxable exchange because there is no other business purpose for the corporation and because the transaction is, in substance, a taxable exchange. *West Coast Marketing Corp. v. Commissioner*, 46 TC 32 (1966).

There is no magic amount of time after electing corporate status that a former partnership should wait before the reorganization occurs. Instead, the principal focus should be on making sure there is some separate business purpose for converting the partnership to a corporation beyond qualifying the exchange for nonrecognition. See Robert R. Keatinge, *Tax Considerations in Choice of Business Entity*, 31ST ANNUAL AMERICAN INSTITUTE ON FEDERAL TAXATION,

Outline 9, at 71 (2007). If the partners anticipate that the business might be acquired by a corporation, it is a good idea to create a corporation well in advance of discussions with a particular buyer. The partners can then move the business assets from the partnership to the corporation as discussions become serious. There is authority to suggest that funding a shell corporation followed shortly by the shell's acquisition by another corporation can qualify as a tax-free reorganization. *Weikel v. Commissioner*, T.C. Memo. 1986-58. *Weikel* has been criticized by other courts. See *Long Term Capital Holdings v. U.S.*, 330 F. Supp. 2d 122 (D. Conn. 2004); *Associated Wholesale Grocers v. U.S.*, 927 F.2d 1517 (10th Cir. 1990). Both of these cases observe that courts can still apply the step transaction doctrine to transactions even where the business purpose for the entity is established.

It is important to note that no such risk exists where the partners wish to take the business public instead of selling it to an acquiring corporation. A last-minute conversion or incorporation of the business on the eve of a public offering does not disqualify the conversion from nonrecognition. This is because the conversion qualifies for nonrecognition under IRC §351, which does not have a continuity of interest requirement that applies to reorganizations under IRC §368(a).

6. The Built-in Gain Problem Under IRC §704(c)

If a partner contributes "built-in gain property" to the partnership, subchapter K and corresponding regulations insure that the contributing partner's built-in gain cannot be shifted to another partner. Built-in gain property is property which, on the date of contribution to the partnership, has a fair market value greater than its tax basis. IRC §704(c)(1)(A); Treas. Reg. §1.704-4. When the partnership disposes of the built-in gain property, the built-in gain *must* be allocated to the contributing partner. IRC §704(c)(1)(A).