Choice of Entity

Eric L. Green, Green & Sklarz LLC, New Haven, CT

Gregory R. Wilson, Attorney-at-Law, San Francisco, CA

Why Form an Entity?

- Define terms of joint ownership, co-owned/managed business (legally enforceable)
- Ability to issue equity to investors, owners separate from management
- Liability Protection
  - Protect owners’ assets outside of entity and protect assets of business from non-entity debts (protection flows both ways)
  - Differences between limited partnerships, LLCs and corporations
    - Limited partnerships require general partner, LPs cannot participate in management
    - LLCs usually have fewer state law entity compliance rules
  - Non-entity forms of business – general partnerships, sole proprietorships – no liability protection – why use?
    - No liability protection needed (e.g., some joint ventures)
    - State law overrides liability protection (e.g., for attorney malpractice)
  - Is insurance alone enough?
- Why not to use an entity - better tax deductions (but what about audit risk)
- Future IRS Issues?

Taxation Differences

- Single Level or Double Level of Tax – C Corp vs. Flow-Through
  - Profits “double taxed” with C corporation – at entity level and, again, at shareholder level when distributed
  - Partnerships, LLCs and S corps are “flow through entities” – profits flow through to owners and, generally, only taxed at shareholder level
  - Preferential Long Term Capital Gain rate N/A for C corps
  - Losses flow-through to owners (but often use is limited)
  - Change in analysis if corporate rate cut to 15%?

Why C Corporation

- Given single level of tax with flow-through entity, why form C corporation:
    - Real Factors
        - Well known/understood and expected
        - Well known/understood and expected employee equity compensation
            - Recruiting/retaining talent major considering in some industries
            - Effectively similar compensation arrangements possible with flow-through entities also – but not as well known/understood and expected
        - Foreign investors/owner
            - Do not want PE/branch in the US
            - Do not want US tax filing requirements
            - Limitations on owners of S corporation stock
        - Investor preference
            - For $10M investment, you pick the entity
    - Maybe Factors
        - Section 1202 Stock (QSBS)
            - Higher exclusion now, more attractive
            - Worth the double taxation for chance 1202 will apply?
    - Illusory Factors
        - Better liability protection (only misperception)
        - Option for tax-deferred reorganization exit
            - Better to take cash if available over stock

Flow-Through Entity Differences

- LLC/Limited Partnership vs. S Corp
  - Limited Partnership require general partner entity, LLCs are generally superior but continue to be formed in certain situations (e.g. part of “legacy arrangements”)
  - Subchapter K provides more than just flow-through taxation – also provides more flexibility to distribute appreciated assets, sell only some assets, specially allocate gain, make disproportionate distributions, multiple classes of equity.
  - Members’ basis in interest increased by share of LLC/LP debt.
  - Owner can be employee of S corp – not of LLC/LP
    - Possible employment tax savings
    - Employee benefits available

S Corps

- Flow through on most items
- Still a C Corp for many items, including sale or distribution of capital assets
- Potential tax savings from SE Tax, but issues with sole shareholder as service provider
- Issues of allocating profits
- Reasonable comp issues (S v C)
- Pitfalls if covert LLC with negative basis to an S Corp
- Estate Planning pitfalls (QSST and ESBT)
  - Amend Trusts for proper language
- LLC Electing S Corporation Status
  - Fewer state law compliance rules
  - Simplicity of S Corporation
  - Possible good choice for simple (asset-light) operating business
  - Caution to use proper form for operating agreement/entity docs

Other Issues

- Expenses (NY Publishing Requirements)
- State Legal Requirements (Mass's old no SMLLC)
- Accounting and tax expenses for separate entities
- Formalities (Stock book)
- Ability to be on payroll (S Corp/C Corp)
- Financing (VC Money)
- Type of assets it will hold?

Common "Default" Choice – LLC

- Best of Several Worlds
  - Flow-through taxation with maximum flexibility
    - Single level of tax – eligible for LTCG rate
    - Losses flow-out to members
    - Basis increased by LLC debt
    - Distribute assets tax-free
    - Sell portion of business/assets
    - Divide up business/assets
    - Specially allocate gain, disproportionate distributions, multiple classes of equity
  - Liability Protection
    - Full state law liability protection
    - No corporate generate partner required
    - No restriction on members' participation in management
    - Minimal state law compliance requirements

Case Study – Existing Business

- New client: existing business – If C Corporation, consider converting to LLC or making S election if desirable and not costly
  - Possibly prompted by new development
    - Profitability of C corporation
    - Offer to sell/considering retirement
      - Too late – consider sale of personal goodwill
    - Owners dispute, desire to separate
  - Impact of S election
    - No deemed liquidation/no current tax on election
      - Built-in-Gains tax
    - Possible late election
  - Impact of converting to LLC
    - Deemed sale of assets for FMV, liquidating distribution to shareholders, often significant tax unless business worthless or has sufficient NOL

Questions/Comments?

CHOICE OF BUSINESS ENTITY

Panelists:
Eric L. Green, Esq., Green & Sklarz LLC, New Haven, CT
Gregory R. Wilson, Esq., Attorney-at-Law, San Francisco, CA[1]

I. WHAT ARE THE CHOICES?

A. General

The choice of the form in which to operate a closely held business is affected by several tax factors. Moreover, even where the initial choice was the correct one given all the prevailing circumstances, the situation or the law may change as we have graphically seen in past legislative session. In any event, however, more than a simple rate comparison must be done. The tax factors that must be analyzed include organization, operation and withdrawal, and sale or termination.

B. Types of Business Entities

Although there are several types of business organizations, the vast majority of cases involve the decision of whether or not to use a pass-through entity. In the context of that decision, the taxpayer(s) must consider whether to incorporate and elect S-corporation status, or if the decision is made to remain unincorporated, the taxpayer(s) must choose amongst becoming a limited liability company, a limited partnership, or a general partnership. All discussions of the tax treatment of partnerships herein will apply to limited liability companies unless otherwise expressly stated. Any differences or additional aspects will be specifically highlighted.

II. THE PARTNERSHIP – CREATION

A. Taxable Year

A partnership has less freedom than a C-corporation in selecting a taxable year. The IRS Commissioner's consent is required for a new partnership to adopt, or for an old partnership to change, to a taxable year that differs from that of the principal partners. Additionally, a business purpose for said change must be established. Assuming these requirements are met, consent will generally be granted where the requested change will not defer income to the partners for a period of more than three months. A partner with a 5% interest in partnership profits or capital is deemed to be a principal partner.

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[1] This outline was originally done Leslie E. Grodd of Halloran & Sage in 2007, and is being used and updated by the panelists with the permission of Attorney Grodd. This is not intended to be an exhaustive treatise on the topic. Rather, it is intended as a survey of the many issues. In addition, the author apologizes in advance for the fact that some of the points covered are less current than others. The reader should independently research these issues before advising clients.

B. Estimated Tax

A partnership itself pays no tax, but a partner must consider his distributive share from the partnership in determining whether he must file a declaration of estimated tax.

C. Organizational Expenses

Even though partnerships and partners can no longer currently deduct the costs of issuing and marketing partnership interests, partnerships, like corporations, may elect to amortize organizational expenses over the 180-month period beginning with the month in which the partnership begins business. If the partnership is liquidated prior to the expiration of such period, the balance may be claimed as a loss.

D. Contributions to the Partnership

If contributions to a partnership are in the form of property, the contributor is usually credited with the fair market value of the property at the time of the contribution. This is generally true regardless of what the contributing partner may have paid for the property. The partnership's basis in the contributed property for tax purposes will be a carryover of the contributing partner's basis, increased by any gain recognized by the contributing partner due to liabilities assumed by the partnership exceeding the property's fair market value. In other words, the partnership's basis will be equal to the adjusted basis of the property contributed. In the case of contributions of cash, both the basis and the amount credited to the partner will be equal to the amount of money contributed. It should also be noted that a partner's share of partnership liabilities is considered a contribution of money. The significance of this point will be discussed further below.

In most cases, no gain or loss is recognized on an exchange of money or property for an interest in a partnership. As mentioned above, however, a contribution of property to a partnership will result in recognizable gain where the partnership assumes a mortgage on a contributed property and the amount of said mortgage exceeds the contributing partner's adjusted basis in the property. In that case, the amount by which such mortgage exceeds the contributing partner's adjusted basis will be taxable to the contributing partner. Additionally, contributions of property on which an investment tax credit has been claimed could potentially trigger recapture of the credit.

An exception to the non-recognition rule of Internal Revenue Code ("IRC") Section 721 exists, however, for transfers to investment companies. A contributing partner must recognize gain on contributed property if the partnership qualifies as an "investment company" under IRC Section 351 and Treas. Reg. 1.351-1(c)(1). Generally, a contribution to a partnership will be treated as a contribution to an investment company if: (1) the transfer results in the diversification of the transferor's interest, and (2) the transferee is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80% of the value of whose assets are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts. Further, it is important to remember the possible impact of state and local conveyance taxes in instances where real estate is to be contributed to a partnership.

A capital partnership interest received in return for services performed generally must be included in the service partner's gross income, although this may not be true if the interest received is limited to a right to share in future profits and losses. The partner who, in return for services, receives an interest in the other partner's capital contributions, receives compensation income to the extent of the fair market value of the interest received at the time of the completion of services. If there are restrictions on the service partner's right to withdraw or otherwise dispose of the capital interest received from the partnership, income is realized and reportable when the restrictions are lifted, subject to earlier recognition upon an election under Section 83(b).

Thus, at the time of organizing a partnership, the service partner and other partner(s) have some control over the time the service partner will be taxed, and are potentially able to postpone tax until sale or liquidation of the partnership interest. The IRS continues to be aggressive in attempting to assess tax on the service-providing partner, regardless of any limitations or restrictions on the interest received, and proposed regulations seeking to clarify the issues have been issued.

A caveat exists with respect to valuation rules for retained interests in family limited partnerships and profit interests given to junior family members under Chapter 14 of the IRC. In that scenario, if the family group owns 50% or more of the partnership's income and capital, the senior family member's capital account will generally be deemed to be an applicable retained interest to be valued at zero. Thus, the transfer to the junior family member will be deemed, for gift tax purposes, to be a transfer of the value of the senior family member's capital account. The value of the gift can be mitigated based on the discounted present value of the right to receive the value of the capital account if either the partnership must pay such account to the parent at a specific time, such as a particular date or at the time of his/her death, or, liquidation at which time the capital account would be paid to the senior family member and cannot be compelled by any combination of the parent or applicable family members.

E. Basis of Partner's Acquired Interest

The basis of a partner's interest acquired in exchange for a contribution of property, including money, to the partnership is the amount of money contributed plus the adjusted basis to the contributing partner of any such property. Example: Individual A, Individual B, and Individual C form a partnership in which they each will be equal partners. Individual A contributes $10,000 in cash to the partnership; Individual B contributes $5,000 in cash plus property worth $5,000, but which cost him $3,000; Individual C contributes property worth $10,000, but which cost him $6,000. Although each partner has an equal 1/3 interest in the partnership, the basis of their interests differ for income tax purposes. The basis of Individual A's interest is $10,000 (i.e. the amount of cash he contributed). Individual B's basis is $8,000 (i.e. the $5,000 in cash plus the $3,000 of adjusted basis in property contributed). Individual C's basis is $6,000 (the adjusted basis of the property he contributed).

If, in addition to the above contributions, the partnership borrowed an additional $6,000, each partner would increase his basis by $2,000 (i.e. his share of the partnership's liability). Transfer of property subject to a liability, to the extent of the fair market value of the property, is considered a transfer of the amount of the liability along with the property.

A decrease in a partner's personal liabilities, on the other hand, due to assumption of those liabilities by the partnership, is treated as a distribution of money by the partnership to the partner, and the basis of each of the partners will be adjusted accordingly.

If a partnership interest is acquired other than through a contribution of money and/or property to the partnership, the basis of the interest is determined under the general basis rules. For example, if an individual receives a gift of a partnership interest, his basis is the same as the donor's in such interest. On the other hand, if the interest is acquired from a decedent, the basis is "stepped up" to the fair market value thereof as of the date of the decedent's death or as of the alternate valuation date.

If a partner pays cash to a partnership in exchange for his partnership interest, his holding period for the interest begins when he acquires the partnership interest. If the contributed property was a capital asset or property used in a trade or business (i.e. a Section 1231 asset) in the hands of the contributing partner, the holding period of the contributed property can be tacked on to the holding period for the partnership interest.

F. Partnership's Basis in Contributed Property

Generally, the basis of property contributed to a partnership is the adjusted basis of the contributing partner, plus any gain that is recognized by that partner. There are, however, special basis adjustment elections, beyond the scope of this outline, which permit limited departures from this rule in cases where a partnership elects that the transfer of a partnership interest shall not affect the basis of the partnership's property because of such transfer. A simpler exception may occur when a partner contributes property which was not depreciable in his hands, but which will be depreciable by the partnership. For example, if he contributes property such as a personal residence or automobile to the partnership, the basis of that property to the partnership is the lesser of (1) the market value of the property at the time of the contribution, or (2) its adjusted basis to the contributing partner.

G. Agreements on Contributed Property

Absent an agreement to the contrary, a partner's share of income, gain, losses, deductions or credits is determined in accordance with his interest in the partnership, taking all facts and circumstances into account. Thus, where property is contributed to a partnership and it has a fair market value substantially less than or greater than its adjusted basis, subsequent tax events may leave one or more of the partners unhappy. For example, say Individual A owns non-depreciable property (e.g. securities) which cost him $5,000 and which have a current fair market value of $10,000. Individual A and Individual B form an equal partnership with Individual A contributing the property and Individual B contributing $10,000 in cash. Since the partnership takes the same basis for the contributed property that Individual A had, the partnership's basis for the property is

$5,000. If the partnership later sells that property for $11,000, it has a taxable gain of $6,000, half of which is allocated to each partner – a result that may not delight B.

In order to rectify situations like the one illustrated above, a partnership agreement may, through special allocations, allocate income (or other items) disproportionately to capital contributions. Partners, for example, may formally agree to allocate depreciation, depletion, gain, or loss in a manner that takes into account any difference between the adjusted basis and fair market value of the contributed property. They may agree to apply the same special ratio to all contributed property, to apply different ratios for different items, or to apply a special ratio only to parts of the contributed property. The total depreciation, depletion, gain, or loss allocated to the partners, however, cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it.

It should be kept in mind that partnership agreements do not give partners unlimited leeway to reallocate income, gain, losses, deductions, or credits. An allocation must have substantial economic effect. That is, such allocations should affect shares of income or loss independently of tax results. The question, as you might imagine, of what constitutes "substantial economic effect" has been the subject of a great deal of litigation and dispute with the IRS. In addition, the Treasury Regulations under Section 704 which deal with this concept are among the most complex regulations that have been promulgated. Within this limitation, however, partnership agreements permit adjustments not available in a corporate framework.

Due to concerns about the possibility of sheltering income by allocating a full share of losses to limited partners joining a limited partnership at the end of its tax year, rules with respect to retroactive allocations exist. Income or loss is allocable to a partner only if paid or incurred during the portion of the year in which the partner was a member of the partnership. In determining when income, loss, or some special item has been paid or incurred, a partnership may allocate items ratably on a daily basis or, in effect, separate the year into segments and allocate items among parties who are partners during such segment.

H. Alternatives to Contributing Property

Partners have various alternatives to direct contributions of property to their partnership. As a general rule, when a partner deals within his partnership in some other capacity, the transaction is treated as if it were between the partnership and an outsider.

Where property has appreciated in value, or has an actual value exceeding its adjusted basis but less than its original cost, a sale of the property to the partnership may be preferable to a direct contribution. A tradeoff, however, is involved. The partnership will get an increased basis, and, if the property is depreciable, the partnership will get larger deductions. The sale is a taxable event, however, for the seller of the property and may result in ordinary income if depreciation recapture is involved. In addition, the effects of the passive loss rules on deductibility of partnership losses need to be factored into this equation. It should be noted that a contribution of cash to a partnership immediately followed by a purchase of such property may result in a contention by the IRS that the cash contribution and sale was, in effect, a direct contribution of property to the partnership. The applicable regulations caution that the substance of a transaction will govern.

A further caution is in order with respect to the sale of property by a partner to his or her partnership. No loss on the sale is deductible where the partner owns 50% or more of the capital interest or profit interest in the partnership. Moreover, where the partner's interest is 50% or more and the property is not a capital asset, any gain is ordinary income. Thus, this latter rule would result in a tax disadvantage in cases involves Section 1231 property which, although not a capital asset, will generally result in capital gain if sold.

In addition to the sale of property to one's partnership, leasing of property to one's partnership may also be acceptable. Assuming that rents reflect fair rental value, they are fully deductible by the partnership and taxable income to the lessor. A gift, coupled with a lease, may be a practical method of splitting taxable income among members of a partner's family.

Direct gifts of a partnership interest may fail to achieve the goals as will be discussed below for family partnerships. It should be noted, however, that the passive loss regulations do not allow rental income from a related entity to be considered passive income.

I. The Family Partnership

One of the prime tax planning goals is to split income among taxpayers so as to take advantage of different tax rates as well as for estate tax reductions. In this regard, the family partnership is a common income splitting device that, when properly structured (subject to challenge with respect to any discounts claimed on the transfer of interests) have been recognized by the IRS. The "kiddie tax" and Chapter 14 rules, however, must also be taken into account when considering this type of entity.

J. Admitting Partners into a Proprietorship

Taking partners into a sole proprietorship is generally a taxable event. In effect, an interest in a going business has been sold and the sole proprietor is deemed to have sold a proportionate interest in each of the underlying assets. New Partners are deemed to have contributed the assets so purchased to the partnership and the sole proprietor is deemed to have contributed the remainder. A non-sale approach to converting a sole proprietorship into a partnership may avoid a taxable event. For example, the proprietor and the new individuals could each contribute their assets and/or money to a new partnership. However, if the transaction is structured in that matter, the parties would want to consider the basis rules discussed above.

III. THE CORPORATION – CREATION

A. Introduction

The tax effect of incorporation is by-and-large controlled by the owners of the business. Incorporation may or may not be a taxable event to the owners. For non-recognition of gain with regard to direct contributions of property, the shareholders must meet the requirements of Section 351. When only cash is transferred to a new corporation or any property transferred has an adjusted basis equal to its fair market value, gain or loss is of no concern. Otherwise, the parties should consider the taxable and tax-free alternatives. In any event the corporation itself realizes no taxable income on receipt of the transferred property, but its basis and holding period is affected by the method of transfer selected. The act of incorporating, though itself is a simple one, is one that is the result of many important and far-reaching decisions.

The parties must decide on the balance between debt and capital investment, whether to initially elect to operate as an S corporation, and even whether to operate through multiple business entities.

B. Timing

Taxpayers who decide to incorporate are faced with a further decision as to when the best time to incorporate may be. Whether the corporation will conduct an entirely new business, or merely continue an old one, a likelihood of early losses may be sound reason for delaying incorporation, or alternatively, to operate as an S corporation. Absent a principal tax avoidance purpose, a corporation's assumption of a taxpayer/incorporator's liabilities not in excess of the contributed property's basis will not generate taxable boot in connection with an otherwise tax-free contribution of property to a controlled corporation. It may still be desirable, however, for a predecessor unincorporated business to pay all of its deductible expenses rather than having the successor corporation assume liability therefor. This is because of the danger, as reflected in various cases, that deductions will be disallowed for payments of a transferor's accounts payable on the theory that they were not actually incurred in the corporation's trade or business. However, it is well established that corporations will be allowed to deduct transferred accounts payable in cases where receivables have also been assigned and the corporation agrees to report the amounts collected as income.

C. The Taxable Year

In contrast to new partnerships discussed above, a new corporation, other than an S corporation or a personal service corporation, may select a taxable year other than a calendar year without the Commissioner's consent. The first taxable year may not exceed twelve calendar months, nor may the taxable year end other than on the last day of a month, except insofar as results from a valid election of a 52-53-week year. Thus, a corporation may initially elect to close its books at the end of any one of its first twelve months of operation, but any change after that typically requires the Commissioner's consent. Any number of factors may impact the choice of a taxable year. For purposes of administrative convenience and formulation of future plans, it may be desirable to take inventories and prepare financial statements within a reasonable time after the peak business season, but closing the first fiscal year just prior to the peak business season may defer considerable tax. On the other hand, if initial expenses are expected to be substantial, allowing the first taxable year to run for the maximum duration might serve to keep a greater amount of income away from higher corporate income tax brackets. In any event, though, calendar quarters must be used for employment tax withholding purposes, and a calendar year must be used for federal employment tax purposes.

D. Organizational Expenses

As discussed above, a corporation, as well as a partnership, may elect to treat its organizational start-up expenditures as deferred expenses. If such an election is made, the expenditures are amortizable ratably over a period of 180 months that the corporation may select. The period must begin, however, with the month in which the corporation begins an active trade or business. The election must be made no later than the time prescribed for filing the return for the corporation's initial taxable year and the expenses may be deducted for tax purposes even though they are reflected on the corporation's books as capital expenditures. Absent such election, these expenses are treated as capital expenditures and are neither deductible as business expenses nor depreciable. They are subsequently taken into account in the year the corporation is liquidated.

E. Tax-Free Transfers of Property

Section 351 provides that no gain or loss is recognized on a transfer of property to a corporation solely for that corporation's stock if, immediately after the exchange, the transferor or transferors own at least 80% of the then issued voting stock and at least 80% of the total number of shares of all of the classes of the corporation's stock. This is true for contributions both at the time of incorporation or at some subsequent date. As stated above, a corporation realizes no gain or loss on a transfer of its stock for money or other property, irrespective of whether the transferor meets the Section 351 requirements for non-recognition of gain or loss on such transfers. The requisite control has to be in the transferor or transferors at the time the transaction is completed. The fact that partnership assets are transferred from the partnership to a corporation without first terminating the partnership and distributing them to the partners will not in itself prevent the control test from being met. Further, if control does exist, it is not necessary that the stock be received by two or more transferors in the same proportions as their interests in the property before the transfer. There is, however, some tax effect with respect to this latter type of transaction which will be discussed below. It should be noted that Section 351 does *not* allow the tax-free receipt of "securities" as well as stock in exchange for contributed property.

If an exchange meets the requirements of Section 351, no gain or loss is recognized regardless of the parties' intent. Therefore, where property can be sold at a loss, alternatives to direct contributions to the corporation ought to be considered.

F. Property vs. Services

Stock issued for services to, or for the benefit of, the issuing corporation will not be regarded as having been issued in return for property, and therefore, will not qualify as a Section 351 transaction. The value of the stock is generally ordinary income and, as such, will be taxable to the person rendering the services in exchange therefor. Moreover, depending upon the percentage represented by those shares, other contributors of property may also be deprived of the benefits of a tax-free Section 351 exchange.

As stated above, where two or more persons transfer property to a corporation, the stock received need not be proportionate to the interests in the property contributed in order for the transaction to qualify for non-recognition of gain or loss. The substantive nature of the transaction will control, and, in the appropriate case, a transaction may be regarded as consisting partially of a gift, a payment of compensation, or the satisfaction of an obligation. For example, assume that Individual A and his son, Individual B, organize a corporation with 100 shares of common stock. Individual A transfers property worth $20,000 in exchange for 20 shares of stock. Individual B transfers property worth $5,000 in exchange for 80 shares of stock. Individual A has no indebtedness to B. No gain or loss is recognized under Section 351, but Individual A is deemed to have made a gift to Individual B of the fair market value of 60 shares of stock on the date issued to him. The gift, presumably worth $15,000, is subject to federal gift tax. If it is determined that the disproportionate distribution reflects a payment to Individual B for services, however, the payment is taxable to him as ordinary income and there is no gift tax exposure.

Contributions of things such as “technical know-how” present classification problems. A broad range of items that fall into the “know-how” category may constitute property for Section 351 purposes. These might include processes, formulae, designs, drawings, technical reports and materials, training materials, and other similar items. Secret information as to a device or process that is in the general nature of a patentable device may also qualify as property. However, if information has been developed specifically for the new corporation, rather than for use in the owner’s prior business, the stock received in exchange for it may be treated as payment for services rendered.

Finally, if a transferor agrees to perform services in connection with a transfer of property, tax-free treatment may still be available if the services to be performed are merely ancillary and subsidiary to the property transferred. Determination of whether the services are ancillary is a question of fact. When both property and services are furnished as considerations, and the services are not merely ancillary and subsidiary to the property transfer, a reasonable allocation must be made.

G. Partially Taxable Transfer: Boot

Although it is not common for transferor/owners to receive additional property (i.e. “boot”) along with corporate stock on transfer of property to the corporation, the receipt of such additional property does not completely destroy the tax free nature of the transaction. The owners are taxed only on the additional property received. Thus, gain is recognized only to the extent of the cash and the fair market value of the property received (including securities other than stock of the corporation) in addition to the stock. The transferee-corporation gets the benefit of a stepped-up basis in the assets they received, but only by the amount of gain taxed to the transferor/owner on the transfer of the boot from the corporation. No loss will be recognized on the transfer, however. Whether the boot is taxed as ordinary income or capital gain depends on the character of the property transferred to the corporation. In the case of a transfer of depreciable property, the depreciation recapture rules of Sections 1245 and 1250 apply.

When several assets are transferred to a controlled corporation, the IRS maintains that each asset is transferred pursuant to a separate transaction. This means that for purposes of computing gain or loss, the fair market value of the consideration received is separately allocated to each transferred asset in proportion to the fair market value of the particular asset. Any resulting loss is not recognized. In addition, and very importantly, a loss in one asset may not be offset against a gain on the other assets.

H. Liabilities

In a typical case, corporations assume liabilities secured by business property transferred to them from predecessor unincorporated businesses. So long as the transfer qualifies as a Section 351 transfer, is motivated by a bona fide business purpose (and *not* tax avoidance), and does not involve any boot, the transaction will be tax-free except to the extent that the liabilities assumed exceed the transferor's adjusted basis in the property.

Accounts payable that would give rise to deductions that cash basis taxpayers transfer to controlled corporations are not liabilities for purposes of the treatment of transfers to which Section 351 applies. Reinforcing a policy of neutrality toward incorporation of a trade or business, this insulates cash basis incorporators from recognition of gain where, if such accounts payable were regarded as liabilities, liabilities assumed by their corporations would exceed the adjusted basis of other transferred property.

I. Basis in the Section 351 Transaction

When property has been transferred to a controlled corporation in a Section 351 transaction, basis must be considered from various points of view. In the first instance, it must be looked at from the aspect of the corporation's basis in the property it has acquired. Secondly, it must be considered in terms of the stockholder's basis in the stock received in exchange for the property. In the latter case, consideration must be given to the situation where (a) just stock is received, (b) where cash is received in addition to stock, and (c) where cash and other property is received by the stockholders. Keep in mind for this purpose that liability assumed on transferred property is treated as cash received by the stockholder in the determination of the stockholder's basis.

The corporation's basis for property acquired from controlling stockholders in exchange for its stock is a carryover basis. It is the same basis that the property had in the hands of the stockholder, plus any gain recognized by the stockholder on the exchange.

When the transferors do not control the corporation immediately after the transfer within the meaning of Section 351, they realized gain or loss in the amount of the difference between the value of the stock received and their basis in the property transferred. The fair market value of the property acquired by the corporation is the fair market value of the stock received by the transferors.

The basis of stock acquired by the transferor/stockholder from the corporation is the same as the basis of the property transferred, decreased by the amount of money or other property (i.e. boot) received, and increased by the amount of gain recognized on the exchange. The basis of other property received on the transfer is its fair market value.

If the property transferred to the corporation is subject to a liability such as a mortgage or other security interest, the assumption of the liability by the corporation is treated as money received by the transferor in the exchange, but only for the purpose of determining his basis (and not gain) for the stock received in the exchange. If the liability assumed by the corporation exceeds the stockholder/transferor's basis in the property transferred, however, the excess of such liability over the property's adjusted basis is treated as gain from the sale or exchange of a non-capital asset, depending on the nature of the encumbered property.

J. Taxable Transfers

Tax-free incorporation is not desirable in all cases. As in the case of partnerships discussed above, the corporation loses a stepped-up basis in appreciated property that it acquires for its stock, and the transferor, in the case of depreciated property, can claim no loss on any transferred property worth less than its adjusted basis. Obviously, in cases of transferred property that has substantially appreciated in value, a higher basis for depreciation purposes can save taxes at ordinary income rates while, subject to holding period requirements, the income generated from the taxable exchange would qualify as long-term capital gain.

Arranging a taxable incorporation so that the basis of appreciated property may be stepped-up or so that a loss may be recognized on depreciated property may not be as easy as it looks on its face. Where the 80% control test is met, non-recognition of gain or loss is automatic, and the subsequent sale of stock to reduce the transferor/incorporator's ownership below the 80% level will not alter this tax result.

K. Loss on Sale to or by a Controlled Corporation

The non-recognition provisions of Section 351 are not the only obstacle to recognition of a loss on an exchange of depreciated property for the stock of a corporation. Section 267 bars the allowance of the loss from the sale of property by an individual to a corporation if the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation. Since gain or loss, as discussed above, is determined separately as to each asset transferred, the application of Section 267 may be particularly harsh. In other words, such "losses" will not ease or offset the impact of any gains.

L. Gain from Transfer to or by a Controlled Corporation

Denial of losses, discussed above, is not the only hazard in sales or exchanges between taxpayers and their related corporations. If transferred property is depreciable in the hands of the transferee and the requisite relationship exists, any gain recognized on the transfer will be treated as ordinary gain. The requisite relationship exists between a corporation and an individual by or for whom 50% or more in value of the corporation's outstanding shares is, directly or indirectly, owned. Ownership is determined by reference to the constructive ownership rules of Section 316, without regard to that section's 50% limitation.

M. Incorporation a Going Business: Retaining Assets

Taxpayers who decide to incorporate an existing business should weigh the advantages and disadvantages of retaining some business assets, either individually or through a partnership. For example, the retention of particular assets might preserve the benefits of particular depreciation methods, avoid conveyance taxes, avoid problems that may arise from a change in accounting methods, or, under some circumstances, prevent acceleration of installment income. Moreover, accounts receivable and goodwill merit special consideration. In the case of an accrual basis taxpayer, the inventory transferred to a newly formed corporation in a Section 351 transaction has a basis equal to the transferor's ending inventory, and accounts receivable will have a basis equal to their net value which is defined as their face amount less previously deducted additions to reserves for bad debts. Ordinarily, there is no compelling reason for retaining inventory or accounts receivable instead of transferring them to the newly formed corporation.

In the case of cash basis taxpayers, a contemplated adoption of the corporation form of business by an existing unincorporated business requires careful consideration. This is particularly true if sales, inventory, and accounts receivable are increasing or are expected to increase in the first two years after the corporate form of business is adopted. C corporations are generally required to use the accrual method of accounting. Personal service corporations, certain non-tax shelter corporations, and corporations with less than $5 million in gross receipts may still use the cash method. Adoption of that method means a significantly higher amount of income in the year that the change was required because the transferred accounts receivable and inventory may be deemed to have a zero basis to the corporation. The resulting income, however, may not need to be bunched since Section 448(d)(7) allows for up to a four year spread of such income using the rules of Section 481.

A taxable incorporation of an existing business which reports its sales on the installment method accelerates the recognition of unpaid installment income. Gain or loss results in an amount equal to the difference between the basis of the obligations and the amount deemed to be realized by the transferor. However, no gain or loss results on a similar transfer in a tax-free incorporation. In the latter case, the transferee simply steps into the transferor's shoes, using the unrecovered costs as its basis for the obligations, and reports the income from collections in the same manner as the original transferor/seller.

N. Capitalizing the Corporation: "Thin" Incorporation

Another factor which must be addressed in choosing the form of organization in which to operate is the leeway to choose the most suitable capital structure. Often the choice between issuing debt instruments, stock, or a combination of both will be dictated by business considerations. While the use of debt instruments instead of stock may create certain tax problems, it may also shield corporate earnings from taxation on two levels. Interest, as opposed to dividends, is a deductible expense, and the payment of debt is not taxable to the creditor while the distribution of capital to a stockholder may involve dividend treatment.

Whether a transfer of money or other property to a corporation creates a debtor-creditor relationship, or whether the transfer gives the transferor an equity interest in the corporation, depends on all the facts and circumstances of a particular case. The Treasury Department has wrestled with this problem for years, and, despite urging from Congress and attempts at codification, regulations as to what constitutes debt and what constitutes equity have not been issued, leaving tax practitioners to advise their clients on a case-by-case facts and circumstances basis. For reference, however, it might be important to note that the enabling legislation with regard to Section 385 enumerates the following five factors that the IRS may consider in distinguishing debt from equity:

1. Whether there is a written unconditional promise to pay on demand or on a specified date at a fixed rate of interest;
2. Whether there is any subordination to or any preference over any corporate indebtedness;
3. The ratio of debt to equity;
4. Whether the "debt" instrument is convertible into stock of the corporation;
5. The relationship between debt and equity holdings.

Some of the factors that may make bonds or debentures desirable may be the very factors that make them look more like equity than debt. Subordination to other creditors, for example, leaves corporate credit unimpaired. In any event, there are no hard and fast rules, and resolution of this problem turns of the particular facts of the particular case.

O. The Small Business Stock Alternative

Losses on stock of corporations that qualify as small business corporations under Section 1244 may be treated as ordinary losses. The maximum amount which may be treated as a loss is $50,000 (or $100,000 for couples filing a joint return) during any taxable year. However, ordinary loss treatment is available only to individuals or individual members of a partnership to whom small business stock is issued. Stock purchased from other shareholders will yield only capital gain or loss on tis subsequent sale or worthlessness. Contrary to the law at the time of enactment of Section 1244, if certain requirements are met, stock may qualify as small business stock even if the parties in interest never gave advanced thought to the matter. To preserve the small business stock alternative, the following requirements must be met: (1) as of the time of issuance of the stock, the aggregate of money and other property received by the corporation as a contribution to capital and as paid in surplus for its stuck must not exceed $1,000,000; (2) the stock must be common stock and issued for money or property (services will not suffice); and (3) the corporation must derive more than half of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

IV. S CORPORATIONS

A. Introduction

An S corporation is one that has elected, by unanimous consent of its shareholders, not to pay a tax on its income at the corporate level. Instead, it has elected to have the shareholders pay taxes on such income, even if such income is not distributed. During tax years prior to 1983, an S corporation, unlike a partnership, was not a conduit. Thus, individual items of income except net capital gains and deductions that pass through to the shareholders did not retain the same character they had in the hands of the corporation. Instead, taxable income was computed at the corporate level in much the same manner as it was computed for any other corporation. The shareholders were taxed directly on this taxable income though the corporation may not have made any distribution to them.

For tax years beginning after 1982, however, a conduit rule applies. Thus, most items of income, deduction, loss and credit pass through and retain their character in the hands of the shareholders. The tax year of a newly formed S corporation, or an existing S corporation that has a more than 50% change in ownership, is required to be a calendar year (known as a permitted year) or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS.

B. Eligibility - Election - Termination

Only a domestic corporation that is not a member of an affiliated group can elect S corporation treatment. A qualifying S corporation may have no more than 100 shareholders. For purposes of this limitation, a husband and wife (and their estates) are counted as a single shareholder without regard to the manner in which they hold their shares. Except with respect to certain trusts, the shareholders must all be individuals (or estates), and no shareholder may be a non-resident alien.

A qualifying S corporation may not have more than one class of stock issued and outstanding. The outstanding shares must be identical as to the rights of the holders in the profits and in the assets of the corporation, but differences in voting rights an1ong shares of common stock are permitted. Furthermore, an instrument that is straight debt is not considered to be a second class of stock.

The election of S corporation status must be made by the corporation on or before the 15th day of the third month of its taxable year in order for the election to be effective beginning with the year when made.. The corporation must meet all the eligibility requirements for the pre-election portion of the taxable year, and all persons who were shareholders during the pre-election portion of the year must consent to the election.

S corporation status may be automatically terminated if any event occurs that would have prohibited the corporation from making the election in the first place. The election will be considered terminated as of the date on which the disqualifying event occurred.. The corporation's taxable year will then be divided into a short S taxable year and a short C (regular) taxable year. An S corporation election may also be revoked with the consent of shareholders holding more than one-half of the shares of stock of the corporation on the day the revocation is made. A revocation which designates a prospective effective date of revocation will be effective on that date. If no date is specified, a revocation made before the 15th day of the third month of a corporation's tax year is retroactively effective on the first day of the tax year. A revocation made after that day without designation of a date is generally effective on the first day of the following tax year.

If an election has been terminated or revoked, the corporation may not, without IRS consent, reelect S corporation status until the fifth year after the year in which the termination or revocation was first effective.... However, if the corporation's S election is inadvertently terminated, the IRS can waive the effect of the terminating event if the corporation completely corrects the event.

C Tax Treatment of Shareholders in General

Each shareholder of an S corporation separately accounts for his pro rata share of the items of income, deduction, loss and credit of the corporation in his tax year in which the corporation's tax year ends. The shareholder's share of each such item is computed on a daily basis according to the number of shares held by him on each day of the corporation's tax year. A shareholder's pro rata share of the net operating loss of the corporation is limited to the sum of the shareholder's adjusted basis in the stock of the corporation plus his adjusted basis of any debt the corporation may owe him. Disallowed losses and deductions may be carried forward to any subsequent year in which the shareholder has an adequate basis in the stock or debt. Following the termination of an S corporation election any disallowed loss will be allowed if the shareholder's basis in his stock is restored by the later of (1) one year after the effective date of the termination, or the due date for the last Subchapter S return, whichever is later; or (2) 120 days after determination that the corporation's S selection had terminated for a previous year.

The amount of any distribution to a shareholder is equal to the amount of cash distributed plus the fair market value of any property distributed. If the corporation does not have any accumulated earnings and profits, the amount of a distribution is tax-free to the extent of the shareholder's basis in the stock. The distribution reduces the shareholder's basis and, to the extent that the amount of the distribution exceeds basis, capital gain results. If the corporation does have accumulated earnings and profits, shareholders receive tax-free treatment with respect to distributions not previously made to the extent of the corporation's Accumulated Adjustments Account (essentially, post 1982 accumulated gross income less deductible expenses). The excess is treated as a dividend up to the amount of pre-1983 accumulated earnings and profits, and any residual amount is applied against the shareholder's basis in his stock. Any amount remaining is then treated as capital gain. In taxable years beginning after 1982, an S corporation can have no current earnings and profits unless attributable to tax years when it was not an S corporation or to S corporation years beginning before 1983.

During the period in which an S corporation election is in effect, the basis of the stock of each shareholder is increased by each shareholder's portion of the following items: (I) all income items of the corporation that are separately stated and passed through to the shareholders; (2) the income of the corporation that is not separately computed; and (3) the excess of the corporation's deductions for depletion over the basis of the property subject to depletion. A shareholder's basis is then decreased by a portion of: (1) non-taxable return of capital distributions by the corporation; (2) all loss and deduction items of the corporation that are separately stated and passed through to shareholders; (3) the non-separately computed loss of the corporation; (4) an expense of the corporation not deductible in computing its taxable income and not properly chargeable to the capital account; and (5) the amount of the shareholder's deduction for depletion with respect to oil and gas wells.

Before applying the distribution rules, the basis of a shareholder's stock and the Accumulated Adjustments Account are first adjusted for the corporate items passed through from the taxable year of the corporation during which the distribution is made. For example, assume that A is an S corporation with no earnings and profits. Assume that B, also an S corporation, has accumulate earnings and profits of $10,000. Assume that in the 1991 taxable year of each corporation, each makes a cash distribution of $100,000 to a shareholder whose adjusted basis for his stock is $70,000. Also, each corporation has an Accumulated Adjustments Account of $50,000. In both cases the first $50,000 would be an adjustment to the Accumulated Adjustments Account, and therefore a return of capital. The next $10,000 in the case of corporation B with earnings and profits would be deemed to be attributable to accumulated earnings and profits, and therefore taxable as ordinary income.. The next $20,000 in both cases would be a reduction of basis of stock and therefore a return of capital and the remaining $20,000 in the case of corporation B with earnings and profits and $30,000 in the corporation A without earnings and profits would be a capital gain.

An S corporation can avoid the priority system for treatment of distributions by electing to treat distributions as dividends. In order to do this, however, all the shareholders who receive a distribution during the taxable year must consent to that treatment. If that election is made, the corporation is not required to distribute its entire Accumulated Adjustments Account at the end of its taxable year before it can pay a dividend.

D. Passive Investment Income

S corporations with Subchapter C earnings and profits and passive investment income totaling more than 25% of gross receipts are subject to a corporate income tax imposed at the highest corporate rate. The tax is applied against the lesser of the S corporation's "excess net passive income" or its taxable income... "Excess net passive income" is that portion of the S corporation's net passive income that bears the same ratio to the total net passive income for the taxable year as the excess gross passive income (defined as gross passive investment income in excess of 25% of gross receipts) bears to the total gross passive investment income for that year..

E. Converting a C Corporation to an S Corporation

This conversion is not deemed to involve a transfer. However, there may be significant other effects, particularly with respect to "built-in gains", net operating losses and other carryforwards. Moreover, as discussed above, S corporations with a C corporation history are potentially subject to the passive investment income tax and to possible loss of S corporation status. This latter pitfall may be avoided by payment of accumulated C corporation earnings as taxable dividends as discussed in Section 1368 (c) and l368(e)(3). Any net operating loss or other carryforwards of a C corporation are not available after conversion to S corporation status in determining the subsequent income taxable to its shareholders. The losses are also not available to the shareholders as they would have been if incurred in an S corporation year.

As part of the repeal of the General Utilities doctrine, the Tax Reform Act of 1986 imposed a tax on "built-in gains" extent at the time of conversion to S corporation status. This was applicable to corporations which filed elections after December 31, 1986 with the exception of certain smaller corporations who qualified for transitional rules and elected to convert to S corporation status prior to 1989. Moreover, it is only imposed if the gain is realized within a ten year period starting from the year of conversion. It should be noted that capital gain is built-in to the extent of net appreciation arising prior to the C corporation's conversion to S corporation status. Built-in gains subject to tax in a year are limited to the excess of the net unrealized built-in gain over the total net recognized built-in gain of prior years in the ten year recognition period. Net unrealized built-in gain is the excess of the fair market value of the assets of the S corporation at the time its S election became effective over the corporation's aggregate adjusted basis in those assets at that time. Recognized built-in gain is any gain previously recognized during the ten year period on disposition of any such assets. It is the corporation's responsibility to show that an asset was not held when its S election became effective or that gain is attributable to appreciation that occurred after the S election became effective in order to exempt the sale of those assets from the tax on built-in gains. The tax is computed by applying the highest corporate tax rate to the corporation's net recognized built-in gains for the tax year. For purposes of the tax, the amount of the net recognized built-in gain is treated as the corporation's taxable income. However, contrary to the general rule with respect to net operating losses, any net operating loss carryforward arising in a tax year in which the corporation was a C corporation is allowed as a deduction against the net recognized built-in gain of the S corporation. Likewise, capital loss carryforwards may also be used to offset recognized built-in gains. In addition, net recognized built-in gain is limited to the lesser of: (1) the amount that would be the taxable income of the S corporation if only recognized built-in gains and recognized built-in losses were taken into account, or (2) the corporation's taxable income. Keep in mind that in the case of a corporation that made its S corporation election on or after March 31, 1988, any net recognized built-in gain that is not subject to current built-in gains tax due to the taxable income limitation is carried forward. Finally, the amount of recognized built-in gain passed through to shareholders is reduced by the tax imposed on the built-in gain at the corporate level.

G. Converting an S Corporation to a C Corporation

The change from S corporation to C corporation status is likewise not a realization event and does not produce significant tax consequences. The major items of concern are loss and other carryovers and previously taxed undistributed income. After the S election termination, there is a transition period of generally one year during which accumulated S period earnings may be distributed without being treated as taxable dividends. Any amounts not so distributed will become subject to the normal C corporation distribution rules. Keep in mind, however, that the accumulated earnings during the period of S corporation status will not be considered earnings and profits and thus may be distributed and applied against basis after all earnings and profits are exhausted. In addition, during the transition period the S corporation's shareholders that have net operating loss carryovers that they have not used because their basis in the S corporation stock had been exhausted, can use them if their basis increases. These items disappear at the end of the transition period. It is important to remember that the earnings of the corporation as a C corporation will not provide an increase in the shareholders basis. Generally, therefore, S corporation shareholders with large unused losses probably should not convert the corporation to a C corporation unless there are other overwhelming factors which would call for such conversion.

V. TAX ADVANTAGES OF LLC OVER S CORPORATION

Although there may be some disadvantage with respect to the treatment of all distributions to a member as self-employment income and hence subject to the 2.9% Medicare tax, an LLC offers advantages over an S Corporation from a tax standpoint.

A Relaxed Ownership Criteria

1. Number of Owners. There is no limit on the number of members of an LLC. An LLC may have more than I 00 members. If an LLC had more than 500 members it would fall outside the publicly traded partnership safe harbor and may be taxable as a corporation.

2 Types of Owners. Similarly, there is no restriction on the type or character of members of an LLC as there is under Section 1361 for S corporation shareholders. Nonresident aliens may own LLC interests. Corporations may own LLC interests. Partnerships and pension plans may own LLC interests. A corporate member of an LLC could be a member of an affiliated group.

B. Group Affiliation.

Both an LLC and an S corporation can own 100% of the stock of another corporation. However, an LLC taxed as a corporation may be part of a consolidated group which files a consolidated return, whereas an S corporation cannot be a member of an affiliated group for consolidated return purposes.

C. Advantages of Partnership Taxation.

Because LLCs are treated as partnerships for tax purposes, the members of an LLC enjoy a variety of tax advantages not available to S Corporation shareholders.

1 Basis Step-up for Liabilities. LLC members will get a basis increase for their share of the LLC liabilities, whereas such an increase is not available for S

Corporation shareholders.

2 Section 754 Election. LLC's, because they are treated as partnerships, can take advantage of the benefits afforded by the section 754 election. As a result, a member can step up its basis in its share of the LLC property to reflect the outside basis in the membership interest

3. Section 704(b) Special Allocations. LLC's, because they are treated as partnerships, can use section 704(b) special allocations. In contrast, if S Corporations attempt provisions similar to special allocations, they would violate the "one class of stock" rule under Section 1361.

VI. TAX ADVANTAGES OF AN LLC OVER A LIMITED PARTNERSHIP

If, from a tax standpoint, partnership tax treatment is what is really desirable, why not use a limited partnership? What advantages do LLCs offer over limited partnerships?

A. Limited Liability.

A key difference between partnerships and LLC's is that an LLC offers limited liability to all its members whereas, in a partnership, even a limited partnership, at least one partner (the general partner) has liability exposure. Although this problem can be handled in a partnership by using a corporate general partner, issues are raised regarding the net worth or capitalization of the general partner, the general partner's minimum interest in the partnership and possible loss of passthrough taxation to the extent of the corporate general partner's interest. In contrast, no member of an LLC has personal liability for the debts of the LCC barring guaranties or other special arrangements.

B. Participation in Management.

LLC members can participate in management of the LLC without risking their limited liability status. In contrast, if a limited partner participates in the day-to-day management of the partnership he may lose his status as a limited partner. Very significantly, this may mean LLC members can participate in management for purposes of the material participation tests of the passive loss rules without losing their liability protection.

VII. TAKING PROFITS OUT OF THE BUSINESS

A. Introduction

Obviously, since businesses are conducted for profit, how withdrawals of profits are treated is a major consideration in selecting the form of business organization. Once that selection is made, partners and sole proprietors need not be too concerned with taxes in deciding how much to withdraw. In the case of a corporation that is not an S corporation, however, many considerations have to be taken into account. Distributions of earnings are taxable to the shareholders who receive them even though the same earnings have already been taxed to the corporation. Where the corporation can use the earnings, and the shareholders can do without distribution thereof, there may be tax advantages depending upon relative tax brackets, of less than complete distributions. As a result of this, the personal holding company tax and the accumulated earnings tax restrict the abuse of unreasonable accumulations of earnings within the corporation.

For the S corporation shareholder, undistributed corporate income generally poses no more problem than undistributed partnership income. It has already been taxed, and its subsequent distribution is not ordinarily a taxable event. But, as stated above, cessation of an S corporation's status can lock in undistributed taxable income which was previously taxed to the shareholders. Once that happens, except as stated in paragraph IV(G), the general rules applicable to distributions from C corporations will then apply to those previously taxed amounts.

B. Partner's Distributive Shares

A distribution of capital, as opposed to a guaranteed payment which is viewed as salary, results in no gain to a partner, except to the extent that any such distribution exceeds the partner's basis in his or her partnership interest. Any such distribution, however, requires an adjustment to the basis of the partner in his or her partnership interest. Such basis is increased by the partner's distributive shares of partnership income and is decreased by the amount of any distributions of current or prior income. Basis is also decreased by a partner's distributive share of losses and of non-deductible expenses that cannot be charged to capital.

When a distribution is made in property, and no liquidation or winding up of the partnership is involved, the adjusted basis of the property is generally the same to the partner as it had been to the partnership just prior to the distribution. A reduction is required for money received in the same transaction and a partner's adjusted basis in property distributed by the partnership may not exceed his or her basis in his or her partnership interest In the case of the distribution of depreciable personal property, followed by a later sale at a gain, prior depreciation at the partnership level will be taken into account in the computation of depreciation recapture.

C. Corporate Distributions

Obviously, since corporate profits are subject to tax at two levels, the tax rules for distributions to shareholders are not parallel to those for distributions to partners. In the case of corporate distributions, the general rules are as follows:

1. If the distribution is a dividend or essentially equivalent to a dividend, the distribution is taxable at ordinary income rates.

2. The portion of the distribution which is not a dividend reduces the basis of the stock.

3. After the basis of the stock is entirely used, the excess is gain from the sale or exchange of property.

Thus, how corporate distributions are taxed to the shareholders depends largely on whether they qualify as dividends, and whether they qualify as dividends depends, among other things, on the existence of earnings and profits.

For income tax purposes, a "dividend" means any distribution by a corporation to its shareholders out of earnings or profits accumulated after February 29, 1913, or out of earnings and profits for the taxable year. If there are no accumulated or current earnings out of which to make distributions, distributions will reduce the basis of stock, and when that basis is exhausted, result in gain from the sale or exchange of property. Keep in mind that earnings and profits does not necessarily correspond to taxable income. For example, income not taxed to the corporation, such as tax-free interest on state and local obligations and the portion of intercorporate dividends shielded by the dividends received deduction, still go into the computation of earnings and profits. Nor, for income tax purposes, do earnings and profits necessarily correspond to the accounting concepts of net income. Allowances for accelerated depreciation, for example, also cannot convert what would otherwise be taxable dividends into return of capital. In general, earnings and profits must be computed on the basis of straight-line depreciation.

Dividends can also take various other forms and in many cases are constructive. Some examples of these are:

1. Stock of another corporation.
2. Bargain purchases and bargain rentals of corporate property to non-corporate shareholders.
3. Unreasonable salary.
4. Loans to shareholders.
5. Interest on notes or bonds which are found to be equity rather than debt.
6. Certain redemptions of stock.
7. Cancellation of debt from a shareholder to his corporation.
8. Payment of personal expenses of the taxpayer/ shareholder by the corporation.

Dividends in a corporation's own stock or rights to receive such stock are not taxable to the corporation's shareholders unless one of the exceptions of Section 305(b) applies.

D Compensation Arrangements for Corporate Employees

Obviously, in light of the above, it becomes important in terms of the overall consideration of the business entity to be chosen to consider some of the ways that money can be taken out of a closely held corporation on a deductible basis (either currently or at some future date without present taxable compensation to the executive shareholder), rather than as a dividend.. There are a number of employee benefits, both major and minor, that are deductible by the employer and non-taxable to the employee. Some are not currently taxable, but become taxable at a later date. And, still others are currently taxable. The following is a brief summary of some of these in the different categories:

1 Benefits not Taxable to the Employee

a. Group term life insurance up to $50,000.
b. Group legal services plans.
c. Employer paid educational assistance under qualified non-discriminatory programs.
d. Business travel expenses.
e. Business meals.
f Medical reimbursement plans, hospitalization and major medical insurance.
g. 500 of entertainment expenses related to the business.
h. Financial counseling expenses (while taxable there may be an offsetting deduction on the employee's tax return).
I. Employee death benefits up to $5,000.
J. Charitable contributions to employee charities.

2. Benefits Not Currently Taxable to the Employee

a. Contributions to qualified retirement plans: Contributions by the employer to qualified pension, profit sharing (including 901(k) plans), stock bonus, employee stock ownership and thrift plans are deductible by the employer in the year made or within a specified period after the close of the year for which made and are not currently taxable to the employee on whose behalf they are made, subject to Code limitations on contributions and fringe benefits. Such contributions and the earnings they accrue become taxable to the employee or his beneficiary only when withdrawn or paid. Contributions made by the employer to individual retirement accounts on behalf of employees are deductible by the employer and currently deductible by the employees. However, the employees will be taxed on withdrawal without the benefit of any special tax favored treatment. The rules with respect to qualified retirement plans also apply to partnerships and other unincorporated businesses.

b. Non-qualified deferred compensation: Subject to meeting the rules of Section 409A, these are plans for a select group of corporate employees, where the employer does not get a current deduction, but where the employee does not currently recognize income provided the amounts contributed are subject to a substantial risk of forfeiture to the employee. The corporation gets a corresponding deduction at the time that the employee reports the income from those plans, which is at the time they are withdrawn, or at the time the amounts no longer are subject to substantial risk of forfeiture. Also allowable without there being the necessity of a substantial risk of forfeiture, once again subject to meeting the rules of Section 409A, are "unfunded" deferred compensation plans.

3. Benefits Currently Taxed to Employees--Favorable Treatment

a. Excess group term life insurance: Employer paid group term insurance in amounts in excess of $50,000 is taxable to the employee on a favorable basis using rates below tl1ose available on an individual underwriting basis and premiums therefor are fully deductible by the employer.

b. Bargain benefits: Economic benefits may be obtained by the employer at a lower dollar cost than the employee would have to pay if he acquired them individually. For example, the employer may be able to purchase cars on a fleet basis. If it transferred a car to an employee as compensation, treating its own cost as an amount of compensation, it would receive a deduction for the full amount of its cost and the employee would be taxed on the same basis. The same result might occur if the employer were to obtain liability insurance for employees on a group basis. Keep in mind, however, if this is offered to non-employee/stockholders a dividend will result.

VIII PLANNING FOR DISPOSITION

A. Introduction

Other than in passing, it may be too much to ask of our clients in the way of future vision to think about the tax consequences of the ultimate disposition of the business at the time of its initial organization. Such consequences, however, may become much more important as the business matures. At such time, it may be appropriate to reevaluate the initial choice of business entity. As discussed below, each entity offers its own advantages and disadvantages with respect to the disposition of a business. For example, only a corporation (including an S corporation) is eligible to participate in a tax-free corporate reorganization and thus be acquired in a nonrecognition transaction. Although a partnership (or limited liability company) may participate in a nonrecognition merger with another partnership (or limited liability company) or in limited circumstances in an acquisitive nonrecognition transaction under Section 351, these forms are much less flexible than the garden variety corporate reorganization. On the other hand, other than with respect to certain S corporations, the repeal of the General Utilities doctrine will make taxable asset sales more expensive for corporations than for partnerships, limited liability companies, or sole proprietorships.

B. Disposition of an Interest in the Business

1. Corporate Stock. The disposition of corporate stock (either in a C or in an S corporation) generally results in capital gain.

2. Partnership Interest. The sale of an interest in a partnership may have

complex tax consequences because of the possible applicability of the collapsible partnership provisions of Section 751 and because there may be special adjustments to the basis of partnership assets for the benefit (or detriment) of the purchasing partner if the Section 754 election is in effect. It is important to note that ordinary income or loss is recognized by the selling partner under Section 751 for a portion of the proceeds attributable to his share of certain assets (unrealized receivables of the partnership or inventory items of the partnership which have appreciated substantially in value). The balance of any gain or loss will be treated as a capital gain or loss. As alluded to above, Section 754 allows for a special election under which the inside basis of partnership property the acquiring partner is adjusted to reflect any difference between the purchase price and the acquiring partner's share of the adjusted basis of the partnership assets. This allows him to avoid recognition of the inherent gains or losses when recognized by the partnership and to have a higher depreciation or amortization basis. Moreover, the selling partner has recognized the corresponding income in connection with the sale of his interest and it would be unfair to tax that income twice. Keep in mind that there are several potential tax consequences when the interest or interests being sold constitute fifty (50%) percent or more of the capital and profits of the partnership and the sale(s) take place within any twelve month period, including a deemed termination of the partnership.

C. Disposition of an Entire Partnership

The disposition may take several forms including the sale of the partnership's assets, the sale of all of the partnership interests, or liquidation of the partnership followed by a sale of the assets by the partners. Each has a somewhat different consequence to the selling partnership's partners and to the purchaser. A disposition of the partnership business by the partnership itself will generally be a taxable transaction with gain or loss recognized on the individual assets. It may, however, be a nonrecognition transaction if the transfer is controlled corporation under Section 351, but such probably more correctly viewed as a change in the form of organization rather than a disposition since the partners must be in control of the corporation to which the assets are distributed, or at the very least be part of a group of other individuals who in the aggregate are in control of the corporation.. Any gain or loss recognized by the partnership on the disposition of its assets will be taxed directly to the partners in accordance with the regular partnership tax rules and transfer will result in an adjustment to the basis of their partnership interests. Any following distribution of the proceeds will be treated under the normal partnership distribution rules.

D. Taxable Corporate Dispositions

A taxable disposition of a corporate business may take the form of either a sale of corporate stock by its stockholders or a sale of corporate assets by the corporation. As stated earlier, the repeal of the General Utilities doctrine reintroduces major tax differences into the choice of an asset sale versus a stock sale.

1. Effect on Corporation of Disposition of its Assets. Since the passage of the Tax Reform Act of 1986, corporate gains or losses on sales of its business or assets in connection with a liquidation will be recognized except as was provided for in the limited transition rules which have expired. Former Section 337 has been repealed. Gains and losses will be computed on an asset by asset basis. Thus, it is critical to advise our clients of the importance of allocating the sales price a1ong the various assets to be sold or purchased since the tax consequences will be substantial. This is particularly true if one is advising a purchaser since the Code requires the allocation of basis to intangibles such as goodwill under the residual method. That is, basis will generally be allocated to other assets to the extent of their respective fair market values and only any premium will be allocated to intangibles. Section 197 requires all intangibles, including goodwill, to be amortized over 15 years. This includes covenants not to compete regardless of their duration.

2. Effect on Shareholders of Liquidating Distributions. Shareholders (including S corporation shareholders) generally recognize capital gain or loss on liquidating distributions. In the case of installment obligations received by the shareholder within twelve months of the sale which gave rise to those installment obligations, the shareholders may generally continue to report their gain on the installment method. Of course, the corporation will recognize its full gain attributable to the sale upon the distribution of the installment notes. Obviously, in the case of an S corporation there would be no corporate level tax unless there was a tax on built-in gain.

3. Sale of Stock. A sale of corporate stock will generally result in capital gain or loss unless the stock is stock of a collapsible corporation. Normally the sale of stock does not affect the corporation sold or its attributes including the basis of its assets. There are, however, certain complex special limitations on net operating and other loss carryforwards after a change in control under Sections 382, 383 and 269. Thus, after the repeal of the General Utilities doctrine there is a substantial difference between the sale of assets followed by a liquidation and the sale of corporate stock. In the former case, there will be two taxes (one on the corporate level and one on the shareholder level) while in the latter case there will be only one tax on the sale of the shares. Mention should also be made of Section 338 which provides a special election for corporate purchasers of eighty (80%) percent or more the stock of a corporation which allows that stock purchase to be treated in effect as an asset purchase. The corporate purchaser may in essence treat the acquired corporation as having made a sale of assets and obtained for it the benefit of a basis in the assets measured by the purchase price of the stock. Section 338 is highly complex and beyond the scope of this outline. It should be noted, however, that it contains provisions requiring that gains recognized by the acquired corporation on its deemed sale of its assets may not be offset against any losses of the acquiring affiliated group, but may be offset against its own losses and loss carryovers and, if a special election is made, against losses of the selling group.

E. Nonrecognition Corporate Dispositions

Obviously the area of tax free reorganizations is beyond the scope of this outline. However, keep in mind that the Code offers several opportunities for these types of transactions including a tax-free merger, or "A" reorganization, a stock for stock "B" reorganization, an assets for stock "C" reorganization and a divisive assets for stock "D" reorganization.