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Choice-of-Entity Decision Guide - Tax Considerations

This Tax-Considerations section of the Choice-of-Entity Decision Guide gives business owners a detailed overview of the different tax regimes that apply to sole proprietorships, C corporations, S corporations, limited liability companies, and partnerships. It includes a discussion of:

- The differences between pass-through and double taxation regimes;
- The tax consequences of capitalization, distributions, and liquidation;
- The various tax rules that can restrict ownership and capital structure.
- Considerations affecting valuation discounts for tax purposes;
- Employment taxes and fringe benefits; and
- State-level franchise tax issues.

The Choice-of-Entity Decision Guide was recently updated to include a commentary on the American Taxpayer Relief Act of 2012 (ATRA), which created a disparity between the top corporate income tax rate and the top individual income tax rate. The Guide discusses how this disparity might influence the choice-of-entity decision.

Section 1.01 C Corporations

The term *C corporation* refers to a corporation that is taxed separately from its owners under Subchapter C of Chapter 1 of the Internal Revenue Code. The term is used to distinguish a C corporation from an S corporation, which is not taxed separately its owners.

Corporations are classified for federal tax purposes as C corporations by default. Any business entity organized under a federal or state statute that describes or refers to the entity as a corporation is treated as a C corporation for federal tax purposes.[1] Certain unincorporated entities—such as publicly traded partnerships, insurance companies, certain state-chartered banks, and government-owned businesses—are also automatically classified as corporations.

Important Note: To convert to a Subchapter S corporation, shareholders of a C corporation must elect to be taxed under Subchapter S of the Internal Revenue Code. The election is made by filing Form 2553, Election by a Small Business Corporation. If the corporation has already operated as a C corporation, the tax consequences of converting to Subchapter S status must be considered.

[1] Treas. Reg. § 301.77-1-2(b)(1), (3).

(a) Double Taxation: Separate vs. Pass-Through Treatment

The federal tax rules governing C corporations are designed to ensure that all income is taxed twice: once at the corporate level and again when distributions are made to shareholders. The C corporation is required to file Form 1120 to report its income and other corporate tax information. While this double tax can be mitigated if the corporation reinvests all profits into the business and does not pay out dividends, the shareholders will eventually be taxed on the earnings when the corporation is liquidated. A reinvestment strategy can also make it difficult to raise capital if, as in many cases, the investors expect return on their investment in the form of dividends. The double taxation inherent in C corporations makes them unattractive in most small-business situations.

(b) Tax Consequences of Capitalization

(1) Shareholder Tax Consequences

Shareholders do not recognize gain or loss on the transfer of assets to a corporation in exchange for stock (capitalization) as long as three requirements are satisfied.

First, the shareholder must transfer "property" to the corporation in exchange for stock. The term *property* includes cash and real or intangible property, but not services.[2]

Comparison to Partnerships and Limited Liability Companies: A partner of a partnership (or member of a limited liability company taxed as a partnership) is *not* taxed on the receipt of an interest in the entity in exchange for services, as long as the interest is a mere profit interest and not a capital interest.[3] This allows the partner to receive a tax-free (but limited) economic interest in the partnership. A shareholder's receipt of stock in exchange for services provided to the corporation is taxable unless the stock is nontransferable or subject to a substantial risk of forfeiture.[4] This often makes a partnership (or limited liability company taxed as a partnership) the preferred choice of entity if the parties wish to provide a tax-free economic interest in exchange for services.

Second, the transfer must be "solely in exchange for stock" in the corporation. If the shareholder receives assets other than stock as part of the transfer, the shareholder is taxed on any gain realized up

[2] I.R.C. § 351(d).
[3] *See* Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191; Notice 2005-43.
[4] I.R.C. §§ 351(d), § 83(a).

to the full value of the non-stock assets received in the transaction.[5] The shareholder cannot, however, deduct any loss recognized in the exchange.

Finally, the shareholder or group of shareholders transferring the assets in exchange for stock must have "control" of the corporation immediately after the exchange.[6] In this context, *control* means that the contributing shareholder or shareholders must own stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.[7]

While the 80% control requirement is easily satisfied when the corporation is first capitalized, it presents problems for later contributions of appreciated assets in exchange for stock. There are situations where less than all of the original contributing shareholders will want to transfer assets to the corporation in exchange for stock. If these new contributing shareholders have less than 80% control of the corporation after the transfer, the contribution does not qualify for tax-free treatment. Instead, the transaction is treated as a sale of the assets to the corporation for fair market value. If the contribution includes appreciated property, the contributing shareholder is taxed on the appreciation.

Comparison to Partnerships and Limited Liability Companies: Partnerships and limited liability companies taxed as partnerships also qualify for tax-free capitalization, but without the 80% control requirement, making them a more flexible business structure for capitalization purposes.

Contributions to an "investment company" do not qualify for tax- free treatment.[8] An investment company is generally defined for this purpose as a corporation in which more than 80% of the fair market value of contributed property (exclusive of cash and nonconvertible debt obligations) consists of publicly traded securities held for investment

If the shareholder's contribution qualifies for tax-free treatment, the shareholder's basis in the stock received in the transaction is the same as the shareholder's basis in the property transferred to the corporation in exchange for the stock, with a few adjustments.[9]

[5] I.R.C. § 351(b).
[6] I.R.C. § 351(a).
[7] I.R.C. §368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.
[8] I.R.C. § 351(e).
[9] I.R.C. § 358. Specifically, the shareholder's basis is decreased by any money received from the corporation, the fair market value of property (other than money) received from the corporation, and the amount of loss the shareholder recognized in the exchange. I.R.C. § 358(a)(1)(A). The shareholder's basis is increased by any amount treated as a dividend and any gain that the shareholder recognized in the exchange. I.R.C. § 358(a)(1)(B).

If the capitalization does not qualify for tax-free treatment, the shareholder's basis equals his or her cost.[10]

Important Note: Special rules apply if the shareholders are contributing property that is subject to a liability.[11] If liabilities exceed the adjusted basis of the contributed assets, the transferring shareholder must recognize gain to the extent of the excess.[12] Similar rules apply to partnerships.[13] This gain recognition can be avoided if the transferring shareholder also contributes a good-faith note in the amount of the difference. It is important to address this issue at the time the organization is first capitalized.

(2) Corporate Tax Consequences

A corporation's receipt of property in exchange for stock is not taxable to the corporation.[14] The corporation's basis in the contributed property equals the shareholder's basis in the property before the transfer, increased by any gain recognized by the contributing shareholder.[15]

(c) Tax Consequences of Distributions

The rules that apply to C corporations are intended to tax income twice: once at the corporate level when the income is earned, and again at the shareholder level when the income is distributed.

(1) Shareholder Tax Consequences

To the extent that a distribution is made from the corporation's earnings and profits, it is taxed to the shareholder as a dividend.[16] The portion of the distribution that is not considered a dividend is applied first to reduce the shareholder's basis in the corporation's stock.[17] Any remaining portion is treated as gain from the sale or exchange of property (capital gain).[18]

Important Note: If a shareholder assumes a liability or takes property subject to a liability, the amount of the distribution is reduced by the amount of the liability.[19] Special rules also apply at the corporate level.[20]

[10] I.R.C. § 1012.
[11] *See* I.R.C. §§ 357; 362(d).
[12] I.R.C. § 357(c).
[13] I.R.C. § 752(c).
[14] I.R.C. § 1032(a).
[15] I.R.C. § 362(a).
[16] I.R.C. §§ 301(c)(1), 316.
[17] I.R.C. § 301(c)(2).
[18] I.R.C. § 301(c)(3).
[19] I.R.C. § 301(b)(2).
[20] *See* I.R.C. §§ 311(b)(2), 336(b).

Special rules apply to distributions to a shareholder in exchange for the shareholder's stock (redemptions). Instead of being treated as dividends, redemptions are treated as a sale or exchange of the stock by the shareholder.[21] The distinction can be important when the longterm capital gains rates (which apply to redemptions) are higher than the tax rates on dividends.

Corporate shareholders may prefer that the distribution be treated as a dividend, allowing the corporation to take advantage of the special dividends-received deduction under I.R.C. § 243 (which allows the dividends only to be taxed once—at the corporate level). On the other hand, individual shareholders often prefer that the distribution be treated as a redemption, for three reasons:

A redemption allows the shareholder to offset his or her basis in a way that is not available with ordinary distributions, which only allow a basis offset if the corporation has no accumulated earnings and profits.

If the shareholder's stock has depreciated, the shareholder can recognize a loss at the time of the redemption. This loss, which is usually a capital loss, can be deducted against capital gains.

A redemption usually results in capital-gain treatment, which can be taxed at preferential rates.

A distribution qualifies as a stock redemption only if it significantly reduces the interest of the shareholder in the corporation. The Internal Revenue Code uses four tests to make this distinction:

Redemptions Not Equivalent to Dividends – A distribution is treated as a stock redemption "if the redemption is not essentially equivalent to a dividend."[22] Although this murky language has been somewhat clarified by rulings and case law, it is not clear enough to rely upon.

Complete Termination of Interest – If the redemption is "in complete redemption of all of the stock owned by the shareholder," the distribution is treated as a stock redemption.[23]

Substantially Disproportionate Distribution – If the shareholder's voting interest is reduced by more than 20% *and* the interest that the shareholder retains after the redemption is not a controlling interest, the distribution is treated as a stock redemption.[24]

[21] I.R.C. § 302(a).
[22] I.R.C. § 302(b)(1).
[23] I.R.C. § 302(b)(3).
[24] I.R.C. § 302(b)(2).

Partial Liquidations – This test views the distribution from the corporation's perspective. It requires (a) that the distribution is not essentially equivalent to a dividend (when viewed from the corporation's perspective); and (b) that the distribution is "pursuant to a plan and [occurs] within the taxable year in which the plan is adopted or within the succeeding taxable year."[25]

To prevent gamesmanship among related parties, Congress has added another layer of rules that must be analyzed to determine if a distribution is a redemption. These attribution rules provide that shares owned by a shareholder's parents, children, and grandchildren (but not siblings) are considered to be owned by the shareholder.[26] Similarly, shares held by corporations, trusts, and partnerships are deemed to be owned by their shareholders, beneficiaries, and partners, and *vice versa*.[27] As a result, shares held by these family members and entities are considered to be owned by the shareholder for purposes of determining whether the distribution qualifies as a redemption.

(2) Corporate Tax Consequences

A corporation will not recognize any gain or loss on a distribution of cash to its shareholders.[28] But if the corporation distributes appreciated property, the corporation must recognize gain as if the property were sold to the shareholder at fair market value.[29]

Important Note: These two rules operate as a loss disallowance system. If the corporation distributes appreciated property, the corporation is taxed on the gain under I.R.C. § 311(b). But that section only covers *gain* on distributions of *appreciated* property. If the corporation distributes property that has depreciated (i.e., property with a built-in loss), I.R.C. § 311(b) does not apply. Instead, the distribution is governed by the general nonrecognition rule of I.R.C. § 311(a), which prevents the corporation from recognizing loss on a transfer of depreciated property.

(d) Tax Consequences of Liquidation

Liquidation is a taxable event for both the shareholder and the corporation. A corporation may liquidate by (a) paying off creditors and distributing the remaining assets in kind to the shareholders; or (b) selling assets, paying off creditors, and distributing the remaining cash to the shareholders.

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[25] I.R.C. § 302(b)(4). Like the "Redemptions Not Equivalent to Dividends" test of I.R.C. § 302(b)(1), this test is usually used only when the safe harbors of I.R.C. §§ 302(b)(2) and 302(b)(3) are unavailable.
[26] I.R.C. § 318(a)(1).
[27] I.R.C. § 318(a)(3) and 318(a)(4).
[28] I.R.C. § 311(a).
[29] I.R.C. § 311(b).

If the corporation makes an in-kind distribution of the assets to the shareholders under a plan of liquidation, it is treated as having sold the assets to the shareholder for fair market value.[30] If the corporation instead sells the assets and distributes the remaining cash to the shareholder, it is taxed on the sale.[31]

Likewise, the shareholder is treated as though the shareholders sold their stock to the corporation for the value of the assets or cash received.[32] The shareholder's basis in property received under a plan of liquidation is the fair market value of the property at the time of the distribution.[33]

Important Note: Special rules apply to distributions involving liabilities.[34]

(e) Restrictions on Ownership

Unlike S corporations, there are no restrictions on ownership of C corporations. C corporation stock may be owned by individuals (including US citizens, resident aliens, and nonresident aliens), partnerships, limited liability companies, any type of trust, and other corporations. A C corporation can have an unlimited number of shareholders.

(f) Restrictions on Capital Structure

Unlike S corporations, C corporations can have more than one class of stock. This allows for differences in voting rights and distributions (including preferred and *non pro rata* distributions).

(g) Adjustments to Basis

The basis in stock inherited from a deceased shareholder is stepped up to the fair market value of the stock on the deceased shareholder's death.[35] But unlike partnerships, corporations cannot adjust the basis of corporate assets after the death of a shareholder.

(h) Valuation Discounts

For estate, gift, and generation-skipping transfer tax purposes, the value of an asset is generally equal to "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts."[36] Because a willing buyer with reasonable knowledge of the facts would pay less for business interests that allow limited participation in the business enterprise or that restrict transferability of the interest, a discount is often available to reflect these restrictions. But restrictions that are more restrictive than state law will generally be ignored.[37]

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[30] I.R.C. § 336.
[31] I.R.C. §§ 1001, 61(a)(3).
[32] I.R.C. § 331.
[33] I.R.C. § 334.
[34] *See* I.R.C. § 336(b).
[35] I.R.C. § 1014.
[36] Treas. Reg. §§ 20.2031-1(b), 25.2512-1.
[37] Treas. Reg. § 25.2704-2(b).

As a result of valuation discounts, transfer of stock in a closely held corporation can often be transferred at a lower value than could a *pro rata* portion of the assets owned by the corporation. This allows assets held by the corporation to be transferred to the next generation at a lower tax cost than if the assets were not held in a corporate form. The amount of the valuation discount depends on the percentage of stock owned by the shareholder and rights and restrictions imposed under state law. Common discounts include a discount for lack of marketability, a discount for lack of control (minority discount), and a discount for built-in gains taxes.

Discount for Lack of Marketability – Unlike interests in limited liability companies or limited partnerships, state law generally imposes no restrictions on transferability of corporate stock. Federal tax law does not tax the shareholders on earnings of a C corporation unless earnings are distributed. This arguably makes C corporation stock more marketable than interests in limited liability companies or limited partnerships. Restricted stock in a C corporation may still qualify for a discount for lack of marketability, depending on restrictions imposed by federal securities law, the company's organizational documents, and shareholder agreements.

Discount for Lack of Control – The stock value of shareholders that do not have a controlling interest in the C corporation should receive a minority discount to reflect the fact that minority shareholders cannot control the affairs of the company, making the shares less desirable to a willing buyer.

Discount for Built-in Gains Taxes – Stock in C corporations should also be discounted to reflect the tax liability in connection with the corporation's built-in gains. While courts and the IRS agree that the discount can apply, there is currently no clear standard for quantifying the built-in gains discount.

(i) Employment Taxes

If the shareholder of a C corporation is also an employee, he or she is treated as any other employee of the corporation. Compensation paid to the shareholder- employee is subject to payroll tax withholding. Other distributions are generally treated as taxable dividends.

(j) Fringe Benefits

Shareholders of C corporations may also be employees, allowing them to take advantage of all nontaxable fringe benefits that are only available to employees.

(k) State-Level Franchise Tax Issues

Although a full discussion of state law tax consequences of choice of entity is beyond the scope of this guide, capital-based franchise taxes should be given careful consideration when choosing a corporate entity. In many states,

corporations are subject to franchise tax, making the corporate form more costly than other alternatives, such as limited liability companies. Consideration of this issue at the time of formation can prevent detrimental tax consequences that could arise if the organization later decides to convert to limited liability company status.

Section 1.02 S Corporations

S corporations provide the liability protection of a corporation with the flow-through taxation of a partnership. Unlike C corporations, S corporations are not taxed separately from their owners. In that respect, they are similar to limited liability companies and some forms of limited partnerships. But because S corporations are subject to burdensome requirements, limited liability companies are often a better choice for small businesses.

The formation of a corporation under state law will automatically classify it as a C corporation for federal tax purposes.[38] To reclassify an S corporation, the shareholders must elect to be taxed under Subchapter S of the Internal Revenue Code. The election is made by filing a Form 2553, Election by a Small Business Corporation.

Important Note: If the corporation has already operated as a C corporation, the tax consequences of converting to Subchapter S status (including the built-in gains tax) must be considered.

(a) Double Taxation: Separate vs. Pass-Through Treatment

S corporations do not pay income taxes. Instead, an S corporation's income, losses, deductions, and credit are passed through to the shareholders for federal tax purposes and taxed directly to them.[39] The S corporation is required to file Form 1120S to report those amounts. This avoids the double taxation that applies to C corporations, but not without exception. Specifically, any gain that an S corporation recognizes within 10 years after electing to reclassify a C corporation as an S corporation is taxed as though the asset were still owned by a C corporation.[40] This "built-in gains tax" is imposed at the highest corporate tax rate.

Double taxation is also a concern for former C corporations with passive investment income.[41] A corporate-level tax is imposed if the S corporation's passive investment income exceeds 25% of its gross receipts and the S corporation has accumulated earnings and profits.[42] The tax is imposed at the highest corporate tax rate. And if the S corporation has both accumulated

[38] Treas. Reg. § 301.77-1-2(b)(1), (3).
[39] I.R.C. § 1366(a)(1); Treas. Reg. § 1.1366-1(a); I.R.C. §1377(a)(1).
[40] See I.R.C. §§ 1374; 1366.
[41] Unlike C corporations, S corporations do not generate earnings and profits. Earnings and profits are only a concern if they are carried over from a period when the S corporation was a C corporation or if the S corporation acquires assets from a C corporation in a tax-free transaction.
[42] I.R.C. § 1375(a).

earnings and profits and excess passive investment income for three consecutive tax years, S corporation status will be lost on the first day of the fourth tax year.[43]

Important Note: Double taxation is a concern only if the S corporation was formerly a C corporation or acquires assets from a C corporation in a nontaxable transaction. It does not apply to assets purchased by the S corporation or contributed to it during the period an S election is in effect.

(b) Tax Consequences of Capitalization

Except as otherwise provided in the Internal Revenue Code, and except to the extent inconsistent with Subchapter S, the provisions relating to C corporations apply to an S corporation and its shareholders.[44] Because the Internal Revenue Code does not contain any special rules for capitalization of S corporations, a shareholder's contribution of stock in exchange for an interest in the S corporation
is governed by the same rules that apply to capitalization of C corporations. See the section of this guide dealing with C corporations for a detailed treatment of these rules.

(1) Shareholder Tax Consequences

S corporation shareholders do not recognize gain or loss on transfer of property to an S corporation in exchange for stock of the corporation if, immediately after the transfer, the contributing shareholders are in control of the corporation.[45] In this context, *control* means ownership of stock possessing at least 80% of the total voting power of all classes of voting stock and 80% of the number of shares of each class of nonvoting stock.[46] A shareholder's receipt of consideration other than the corporation's stock is taxable up to the fair market value of the non-stock consideration, but the shareholder cannot recognize loss on the transfer.[47] A shareholder's contribution of services to an S corporation in exchange for stock does not qualify for tax-free treatment.

Comparison to Partnerships and Limited Liability Companies: A partner of a partnership (or member of a limited liability company taxed as a partnership) is *not* taxed on the receipt of an interest in the entity in exchange for services, as long as the interest is a mere profit interest and not a capital interest.[48] This allows the partner to receive a tax-free (but limited) economic interest in the partnership. A shareholder's receipt of stock in exchange for services provided to the corporation is taxable unless the stock is

[43] I.R.C. § 1362(d)(3).
[44] I.R.C. § 1371.
[45] I.R.C. § 351(a).
[46] I.R.C. §368(c); Rev. Rul. 59-259, 1959-2 C.B. 115.
[47] I.R.C. §351(b).
[48] *See* Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191; Notice 2005-43.

nontransferable or subject to a substantial risk of forfeiture.[49] This often makes a partnership (or limited liability company taxed as a partnership) the preferred choice of entity if the parties wish to provide a tax-free economic interest in exchange for services.

The shareholder's basis in the stock received from the corporation is initially determined using the C corporation rules. Assuming the transfer qualifies as a tax-free capitalization, the shareholder's initial basis equals the adjusted basis of any property and cash contributed to the corporation, increased by any gain recognized and decreased by the fair market value of any assets other than stock received from the corporation and by any loss recognized on the transfer.[50] If the capitalization does not qualify for tax-free treatment, the shareholder's basis equals the amount paid for the stock.[51]

Important Note: Special rules apply if the shareholders contribute property subject to a liability.[52] If liabilities exceed the adjusted basis of the contributed assets, the transferring shareholder must recognize gain to the extent of the excess.[53] Similar rules apply to partnerships.[54] This gain recognition can be avoided if the transferring shareholder also contributes a good-faith note in the amount of the difference. It is important to address this issue at the time the organization is first capitalized.

Later transfers of property to a corporation are treated the same as initial transfers. The transfer is not taxable if the shareholders transfer property solely in exchange for stock and, immediately after the exchange, the contributing shareholders own at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.[55]

Important Note: The 80% control rule can be problematic if a contribution of appreciated property is made at a later time by less than all of the original contributing shareholders. If one or more shareholders want to contribute appreciated property to the corporation and, immediately after the transfer, those these newly-contributing shareholders will have less than 80% control, the contribution will *not* qualify as a tax-free contribution.

[49] I.R.C. §§ 351(d), § 83(a).
[50] I.R.C. § 358(a).
[51] I.R.C. § 1012.
[52] *See* I.R.C. §§ 357; 362(d).
[53] I.R.C. § 357(c).
[54] I.R.C. § 752(c).
[55] I.R.C. §§ 351(a); 368(c).

Comparison to Partnerships and Limited Liability Companies: Partnerships and limited liability companies taxed as partnerships also qualify for tax-free capitalization, but without the 80% control requirement, making them a more flexible business structure for capitalization purposes.

(2) Corporate Tax Consequences

An S corporation's receipt of property in exchange for stock is not taxable to the corporation.[56] The corporation's basis in the contributed assets is equal to the contributing shareholder's basis in the property before the transfer, increased by any gain recognized by the shareholder.[57]

(c) Tax Consequences of Distributions

An S corporation's income, losses, deductions, and credit are passed through to the shareholders for federal tax purposes and taxed directly to them.[58] Because the income of S corporations is taxed to the owners when the income is earned, a mechanism is needed to ensure that the shareholder is not taxed again when the earnings are distributed. This is done through a system of rules that track and adjust the shareholder's stock basis. While there are some differences, the S corporation basis system is similar to the rules that apply to partnerships.

(1) Shareholder Tax Consequences

The tax consequences of distributions by an S corporation to a shareholder depend on the shareholder's basis in the S corporation stock. Distributions to the shareholder are not included in the shareholder's gross income to the extent that the distribution does not exceed the shareholder's basis in the stock.[59] If the amount of the distribution exceeds the shareholder's basis, the excess is taxed to the shareholder as capital gain.[60]

Because the tax consequences of distributions depend on the shareholder's basis, it is important to keep up with changes in the shareholder's basis over time. A shareholder's basis in his or her S corporation stock is increased by the share of the S corporation income that is passed through to the shareholder.[61] This effectively gives the shareholder a credit to apply against the earned income when it is ultimately distributed to the shareholder, ensuring that the income is only taxed once.

The shareholder's basis is decreased (but not below zero) by the shareholder's share of the S corporation's items of loss and

[56] I.R.C. § 1032(a).
[57] I.R.C. § 362(a).
[58] I.R.C. §§ 1366(a)(1); 1377(a)(1).
[59] I.R.C. § 1368(b)(1).
[60] I.R.C. § 1368(b)(2).
[61] I.R.C. § 1367(a)(1).

deduction, nondeductible expenses (except expenses that are not chargeable to the capital account), depletion deduction for oil and gas property, and distributions to the shareholder that are not made from accumulated earnings and profits.[62] This helps ensure that the shareholder only benefits once from reductions in income earned by the S corporation.

(2) Corporate Tax Consequences

Like C corporations, S corporations do not recognize any gain or loss on a distribution of cash to its shareholders unless it makes a distribution of appreciated property, in which case the corporation must recognize gain as if the property were sold to the shareholder at fair market value.[63]

Important Note: Special rules apply if the S corporation has accumulated earnings and profits.[64]

(d) Tax Consequences of Liquidation

Liquidation of an S corporation is governed by the same rules that apply to liquidation of a C corporation. If the corporation makes an in-kind distribution of the assets to the shareholders under a plan of liquidation, it is treated as having sold the assets to the shareholder for fair market value.[65] If, on the other hand, the corporation sells the assets and distributes the remaining cash to the shareholder, it is taxed on the sale.[66] In either case, the resulting gain or loss is passed through to the shareholder,[67] and the shareholder receives a corresponding adjustment to basis of S corporation stock.[68] The shareholder's basis in property received as part of the liquidation equals the property's fair market value.[69]

Important Note: Special rules apply to distributions involving liabilities.[70]

Comparison to Partnerships and Limited Liability Companies: In the partnership context, no gain or loss is recognized on a distribution of money or property to a partner.[71] This allows partners to defer recognition of gain in appreciated property that they receive from the partnership. In contrast, distributions of appreciated property by C corporations and S corporations are treated as though the property were sold to the shareholder at fair market value.[72]

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[62] I.R.C. § 1367(a)(2).
[63] I.R.C. § 311(a), (b).
[64] *See* I.R.C. § 1368.
[65] I.R.C. § 336.
[66] I.R.C. §§ 1001, 61(a)(3).
[67] I.R.C. § 1366(a).
[68] I.R.C. § 1367(a).
[69] I.R.C. § 334.
[70] *See* I.R.C. § 336(b).
[71] I.R.C. § 731(b).
[72] I.R.C. § 311(a), (b).

(e) Restrictions on Ownership

Unlike C corporations, ownership of S corporations is restricted. An S corporation cannot have more than 100 shareholders.[73] For purposes of this 100- shareholder limit, husbands and wives (and their estates) and certain family members are treated as a single shareholder, and stock owned by both a grantor trust and the grantor of the trust is treated as being owned by one shareholder.

The Internal Revenue Code also restricts the types of shareholders that can qualify as "eligible shareholders" of S corporations. Eligible shareholders include individuals, decedents' estates, bankruptcy estates, certain types of trusts, or charitable organizations.[74] No shareholder may be a nonresident alien or individual married to a nonresident alien who has a current ownership interest in his or her stock under local law (unless the nonresident alien spouse elects to be taxed as a U.S. resident under I.R.C. § 6013(g)).[75]

(f) Restrictions on Capital Structure

Unlike C corporations, S corporations can only have one class of stock. The corporation is treated as having only one class of stock if all shares of stock have identical right to distributions and liquidation proceeds and the corporation has not issued any instrument or obligation or entered into any arrangement that may be treated as a second class of stock.[76] The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial
contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

Differences in voting rights are disregarded for purposes of determining whether the corporation has more than one class of stock.[77] If all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.[78]

Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical

[73] I.R.C. § 1361(b)(1)(A).
[74] I.R.C. § 1361(b)(1)(B).
[75] I.R.C. § 1361(b)(1)(C); Treas. Reg. § 1.1361-1(g)(1).
[76] Treas. Reg. § 1.1361-1(l).
[77] I.R.C. § 1361(c)(4).
[78] Treas. Reg. § 1.1361-1(l).

distribution and liquidation rights unless: (a) a principal purpose of the agreement is to circumvent the one class of stock requirement; and (b) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.[79]
Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights. Similarly, good-faith agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.

(g) Adjustments to Basis at Death

Stock owned by a deceased Subchapter S corporation shareholder is entitled to a basis step-up at the deceased shareholder's death.[80] But the S corporation's basis in the underlying assets is not affected by the shareholder's death. This means that the sale of appreciated assets by the corporation results in taxable gain to the corporation, and that gain is passed through to the deceased shareholder's estate or heirs.

Even though the S corporation's assets do not receive a basis step-up upon a shareholder's death, the deceased shareholder's estate may be able to leverage the stepped-up basis of the deceased shareholder's stock to reduce tax on the sale of the assets. To do so, the corporation must liquidate and distribute assets in the year of the deceased shareholder's death. The liquidating distribution is treated as
a sale—a payment in exchange for the deceased shareholder's stock.[81]

At the corporate level, this deemed sale results in gain to the S corporation, which is passed through to the estate of the deceased shareholder.[82] When added to the basis step-up to fair market value by virtue of the deceased shareholder's death under Code § 1014, the deemed sale increases the basis of the deceased shareholder's stock in excess of the fair market value.[83] This gives the deceased shareholder's estate an extra amount of basis.

Because the deceased shareholder's basis exceeds the fair market value of the stock (due to the enhanced basis increase), the estate is treated as having a capital loss. This capital loss offsets the estate's gain from the deemed sale (a wash for capital gain purposes). The estate's basis in property received as part of the liquidation equals the property's fair market value.[84] This effectively gives the
estate a full basis step-up in the S corporation's underlying assets even though the

[79] Treas. Reg. § 1.1361-1(l)(2)(iii).
[80] I.R.C. § 1014.
[81] I.R.C. § 336.
[82] I.R.C. § 1366(a).
[83] I.R.C. § 1367(a)(1).
[84] I.R.C. § 334.

deceased shareholder only owned stock (and not the underlying assets) at the time of death.

Whether this liquidation technique will be beneficial depends on the circumstances, including whether liquidation of the S corporation is a feasible alternative. This technique is often helpful in situations where the S corporation's assets need to be sold to pay debts, estate taxes, or to fund distributions. If there are multiple shareholders, however, the tax consequences to the surviving shareholders must be analyzed separately since they will not have the benefit of a basis step-up in their S corporation stock.

Important Note: When using this liquidation technique, timing is critical. In order to take advantage of the shareholder's capital loss, the gain must be recognized in the same taxable year.

(h) Valuation Discounts

For estate, gift, and generation-skipping transfer tax purposes, the transfer of stock in a closely held corporation can be transferred at a lower value than could a pro-rata portion of the assets owned by the corporation. This allows assets held by the corporation to be transferred to the next generation at a lower tax cost than if the assets were not held in a corporate form. The amount of the valuation discount depends on the percentage of stock owned by the shareholder and rights and restrictions imposed under state law. Common discounts include a discount for lack of marketability, a discount for lack of control (minority discount), and a discount for built-in gains taxes.

Discount for Lack of Marketability – Although state law imposes no restrictions on who can own an S corporation, federal tax law restricts ownership to certain eligible classes of shareholder and restricts the number of shareholders. Federal law also taxes S corporation shareholders on earnings of the corporation regardless of whether distributions are made. These factors can help support a discount for lack of marketability.

Discount for Lack of Control – The stock value of shareholders that do not have a controlling interest in the S corporation should receive a minority discount to reflect the fact that minority shareholders cannot control the affairs of the company, making the shares less desirable to a willing buyer.

Discount for Built-in Gains Taxes – Stock in S corporations should also be discounted to reflect the tax liability in connection with the corporation's built-in gains.[85] But there is currently no clear standard for quantifying the built-in gains discount.

(i) Employment Taxes

Profit distributions to a shareholder from an S corporation are not considered "wages" for purposes of Code §§ 3121(a) and 3306(b) and are thus not subject to

[85] *See Estate of Litchfield v. Comm'r*, 97 T.C.M. (CCH) 1079 (2009) (permitting built-in gain discount for S corporation in which sales of corporate assets were likely to occur within ten-years of the I.R.C. § 1362(a) election).

employment taxes. But payments received by the shareholder as compensation for services performed as an employee of the S corporation are subject to employment taxes. This differing treatment creates an incentive for shareholders of closely-held S corporations to receive more of their compensation in the form of profit distributions and less in the form of salary. The IRS has aggressively attacked unreasonably low salary payments to S corporation shareholders-
employees and has successfully recharacterized those profit distributions as wages subject to employment taxes.[86]

(j) Fringe Benefits

An S corporation is treated as a partnership for purposes of applying the fringe benefit rules, with each shareholder owning more than two percent treated as a partner.[87] Any fringe benefits paid to a shareholder owning more than two percent of the corporation is treated like partnership guaranteed payments and must be reported on the shareholder's Form W-2. The S corporation may take a
corresponding deduction for the cost of fringe benefits paid to shareholders with more than two percent interest in the corporation. Fringe benefits available to more-than-two-percent shareholders include:

> **Working Condition Fringe Benefits** – A working condition fringe benefit is any property or service provided to an employee to the extent that, if the employee had paid for the property or service, the payment would have been deductible under I.R.C §§ 162 or 167 as a business expense. Tax-free working condition fringe benefits include business-related use of an automobile, business-related use of country club dues paid by the corporation, job-related education expenses, and job-placement assistance.
>
> ***De Minimis* Fringe Benefits** – Shareholders may receive *de minimi*s fringe benefits, such as tax-free meals (supper money) and local transportation fare for overtime work, traditional birthday and holiday gifts with low value, occasional tickets to recreational events, and traditional gifts for length of service.
>
> **Dependent Care Assistance** – A shareholder may receive tax free any amounts provided under a written plan of the corporation, up to $2,500 annually ($5,000 for a married person).
>
> **Educational Assistance Programs** – Shareholders may take advantage of employer-provided educational assistance up to the applicable limits, regardless of whether it is job related.

(k) State-Level Franchise Tax Issues

Although a full discussion of state law tax consequences of choice of entity is beyond the scope of this guide, capital-based franchise taxes should be given

[86] *See* Rev. Rul. 74-44, 1974-1 C.B. 287; Joseph *Radtke, S.C. v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989) *Dunn & Clark, P.A. v. Comm'r*, 853 F. Supp. 365 (D. Idaho 1994); Priv. Ltr. Rul. 95-30-005 (April 26, 1995).
[87] I.R.C. § 1372.

careful consideration when choosing a corporate entity. In many states, corporations are subject to franchise tax, making the corporate form more costly than other alternatives, such as limited liability companies. Consideration of this issue at the time of formation can prevent detrimental tax consequences that could arise if the organization later decides to convert to limited liability company status.

Section 1.03 Partnerships and Limited Liability Companies

Under state law, a partnership is generally defined as "an association of two or more persons to carry on as co-owners a business for profit."[88] But for federal tax purposes, the definition of a partnership is much broader and includes any "syndicate, group, pool, joint venture, or other unincorporated organization through, or by means of which any business, financial operation, or venture is carried on and which is not … a corporation or trust or estate."[89]

Any business entity[90] with more than one owner that is not classified as a corporation is, by default, characterized as a partnership.[91] This default characterization applies to limited liability companies. In other words, unless a limited liability company elects to be classified for tax purposes as a corporation, it is treated as a partnership for federal tax purposes.

Important Note: Because limited liability companies are taxed by default as partnerships for federal tax purposes, all discussions of *partners* and *partnerships* in this section apply equally to *members* and *limited liability companies* as the context requires.

An entity classified as a partnership becomes disregarded as separate from its owner for federal tax purposes if ownership is reduced to a single person or entity, in which case it is treated as a sole proprietorship.[92] This would include a single-member limited liability company that does not elect to be treated as a corporation. Because single-member limited liability companies generally offer creditor protection without requiring a separate tax return, they are often the
preferred form for single-owner small businesses.

Important Note: A qualified joint venture conducted by a husband and wife who file a joint return for a tax year is *not* treated as a partnership for federal tax purposes.[93] Instead, all items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture and each spouse must take into account such spouse's
respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor. But this treatment only applies to qualified joint ventures. A business owned and operated by the spouses through a state law entity (partnership or limited liability company) does not qualify for the election. *See* Rev. Proc. 2002-69, 2002-2 C.B. 831, for special rules applicable to state law entities owned by husband and wife in community property states.

[88] Uniform Partnership Act § 6.

[89] I.R.C. § 761(a).

[90] A "business entity" such as a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits. Treas. Reg. § 301.7701-1(a)(2).

[91] Treas. Reg. § 301.7701-2(c); Treas. Reg. § 301.7701-3(b)(1)(i).

[92] Treas. Reg. § 301.7701-3(f)(2).

[93] I.R.C. § 761(f)(1).

Like S corporations (and unlike C corporations), partnerships and limited liability companies are *pass-through entities*, meaning that the entity does not pay tax on its income. Instead, each owner must report his or her share of the entity's items of income and loss on his or her own tax return. This ensures that business income is taxed only once—at the owner level.

(a) Double Taxation: Separate vs. Pass-Through Treatment

Unlike C corporations, the income of partnerships is subject to a single level of tax at the partner level. The partnership functions as a conduit to pass income and deductions through to the partners. The partnership is required to file Form 1065 to report income and deductions.[94] This return shows each partner's distributive share of the partnership's income and deductions. Each partner must include that partner's share of the partnership income and deductions on his or her personal tax return.[95]

(b) Tax Consequences of Capitalization

(1) Partner Tax Consequences

Contributions to a partnership are generally tax free. No gain or loss is recognized by a partnership or any of its partners as a result of a contribution of property by a partner to the partnership in exchange for a partnership interest.[96]

As a general rule, a contribution of services in exchange for a partnership interest will not qualify for tax-free treatment.[97] As a result, the interest received is taxable to the partner. The timing of the income recognition depends on whether the partner's right to withdraw from the partnership or dispose of the partnership interest is restricted and other facts and circumstances.[98] But if a person receives a *mere profits interest* for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of becoming a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for
the partner or the partnership, as long as:

the profits interest does not relate to a substantially certain and predictable stream of income from partnership assets, such as income from high- quality debt securities or a high-quality net lease;

within two years of receipt, the partner does not dispose of the profits interest; or

[94] I.R.C. § 6031(a), (e); Treas. Reg. § 1.6031-1(a)-(1)(a).
[95] I.R.C. § 702.
[96] I.R.C. § 721(a).
[97] Treas. Reg. § 1.721-1(b)(1).
[98] *Id.*

the profits interest is not a limited partnership interest in a "publicly traded partnership" within the meaning of I.R.C. § 7704(b).[99]

A *profits interest* is one that does not give the owner any interest in the current assets or the entity or the right to receive distributions on liquidation.

Comparison to Corporations: A shareholder's receipt of stock in exchange for services provided to the corporation is immediately taxable unless the stock is nontransferable or subject to a substantial risk of forfeiture.[100] This mirrors the treatment of a partner's exchange of services for a capital interest in a partnership. But, unlike corporations, a partnership allows the partner to receive a non-capital profits interest on a tax-free basis.

Gain must be recognized on the contribution of property to a partnership that would be considered an "investment company" if it were incorporated.[101] An *investment company* is a partnership in which more than 80% of the fair market value of contributed property (exclusive of cash and non-convertible debt obligations) consists of publicly traded securities held for investment.[102]

The partner's basis in the partnership interest acquired in exchange for a contribution of property to the partnership equals the amount of money and the partner's adjusted basis in any property contributed to the partnership, plus the amount of gain (if any) recognized by the contributing partners for transfers to an investment company.[103]

Important Note: Special rules apply if the partners are contributing property that is subject to a liability. If the partnership assumes any of the contributing partner's liabilities, the assumption is treated as a distribution of money to the partner.[104] Similar rules apply to corporations.[105]

(2) Partnership Tax Consequences

No gain or loss is recognized by a partnership as a result of a contribution of property by a partner to the partnership in exchange for a partnership interest, regardless of when the contribution occurs.[106] The partnership's basis in property contributed to the

[99] Rev. Proc. 93-27, 1993-2 C.B. 343. *But see* Notice 2005-43 (June 13, 2005).
[100] I.R.C. §§ 351(d), § 83(a).
[101] *See* I.R.C. § 351(e).
[102] I.R.C. § 721(b).
[103] I.R.C. § 722.
[104] I.R.C. § 752(b).
[105] I.R.C. § 357(c).
[106] I.R.C. § 721(a).

partnership in exchange for a partnership interest equals the contributing partner's basis in the contributed property, increased by any gain recognized by the contributing partner for transfers to an investment company.[107]

(c) Tax Consequences of Distributions

Unlike the rules that apply to C corporations that tax income both at the entity and at the owner levels, the partnership rules are designed only to tax income once— at the owner level. A partnership's income, losses, deductions, and credit are passed through to the partners for federal tax purposes and taxed directly to them, regardless of when income is distributed.[108]

Since the partners have already paid tax on the income when it is earned, a complex system of rules applies to prevent double taxation when the income is later distributed to the partners. These rules (a) allocate the partnership's income, losses, deductions, and credit among the partners; and (b) adjust basis to reflect each partner's allocation of those items.

(1) Partner Tax Consequences

As with S corporations, the tax consequences of a distribution to a partner are heavily dependent on the partner's basis in his or her partnership interest. A partner's initial basis in his or her partnership interest depends on how the partner acquired the interest. If the partner acquired the interest in exchange for a contribution to the partnership, his or her basis generally equals the amount of money and the partner's adjusted basis in any property
contributed to the partnership.[109] If the property is subject to indebtedness at the time of the contribution, the partner's basis is reduced by the portion of the debt that is assumed by the other partners.[110] If the partner acquired his or her interest in exchange for services, his or her basis equals the value of services provided.[111] If the partner purchased his or her partnership interest, his or her basis equals his or her cost.[112]

The partner's initial basis is adjusted to give effect to transactions affecting the partnership. The partner's basis in his or her partnership interest in increased by:

Any further contributions the partner makes to the partnership;[113]

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[107] I.R.C. § 723.
[108] I.R.C. § 702.
[109] I.R.C. § 722.
[110] Treas. Reg. § 1.722-1.
[111] *Id.*
[112] I.R.C. §§ 742, 1012.
[113] I.R.C. § 722.

Any amount paid for additional interests in the partnership;[114]

An increase in the partner's share of partnership liabilities (which are treated as a deemed contribution to the partnership by the partner);[115] and

The taxable and tax-exempt income of the partnership that is allocated to the partner, including the excess of percentage depletion deductions over the basis of the property subject to depletion.[116]

The partner's initial basis in the partnership interest is decreased (but not below zero) by:

The partner's adjusted basis in any partnership interest that is sold or transferred;

Any decrease in his or her share of partnership liabilities (which are treated as a deemed distribution by the partnership to the partner);[117]

Distributions from the partnership;[118]

The partner's distributive share of losses of the partnership and nondeductible expenditures of the partnership that that are not properly chargeable to a capital account;[119] and

The amount of the partner's depletion deduction for any partnership oil and gas property (but only to the extent that the deduction does not exceed the proportionate share of the basis in the property allocated to the partner.[120]

These basis adjustments depend in large part on the allocation of partnership income, gains, losses, deductions, and credit among the partners. The partnership agreement determines the allocation of these items.[121] If the partnership agreement is silent, these items are allocated in accordance with the partnership interests.[122] If the partnership agreement allocates partnership items among the

[114] I.R.C. §§ 742, 1012
[115] I.R.C. § 752(a); Treas. Reg. § 1.752-1(b).
[116] I.R.C. § 705(a)(1).
[117] I.R.C. § 752(b); Treas. Reg. § 1.752-1(c).
[118] I.R.C. § 705(a)(2).
[119] *Id.*
[120] I.R.C. § 705(b)(3).
[121] I.R.C. § 704(a).
[122] I.R.C. § 704(b)(1).

partners, the allocation is respected as long as one of the following is true:

> The allocations have *substantial economic effect*.[123] Substantial economic effect requires that the partner's capital accounts are determined and maintained in accordance with the Treasury Regulations; that liquidating distributions are made in accordance with capital account balances; and that a partner with a deficit in his or her account balance must restore the amount of the obligation to the partnership.[124] The allocation must also affect the dollar amounts received by the partners from the partnership (apart from tax consequences).[125]
>
> The allocations are in accordance with the partnership interests.
>
> The allocations are deemed to be in accordance with the partnership interests pursuant to one of the special rules contained in the Treasury Regulations.[126]

If an allocation does not meet one of these requirements, the allocation of income, gain, loss, deduction, or credit is reallocated in accordance with the partner's interest in the partnership.[127] Special rules apply to allocations of property with built-in gain and loss.[128]

Important Note: The rules governing substantial economic effect are complex and must be given special consideration if the partnership agreement or operating agreement provides for allocations other than in accordance with each partner's interest in the partnership.

These adjustments to basis coordinate with the rules governing distributions to ensure that partnership income is taxed and deductions are taken only once. A partner will not recognize gain or loss on a distribution with three exceptions:

> A partner will recognize gain if money is or marketable securities are distributed to him or her and the value exceeds the partner's adjusted basis in

[123] Treas. Reg. § 1.704-1(b)(2)(i).
[124] Treas. Reg. § 1.704-1(b)(2)(ii).
[125] Treas. Reg. § 1.704-1(b)(2)(iii).
[126] Treas. Reg. § 1.704-1(b)(1).
[127] *Id.*
[128] I.R.C. §§ 704(c)(1)(B), 737; Treas. Reg. § 1.704-4(a)(5), Ex. (1).

his or her partnership interest as determined immediately before the distribution.[129]

In some circumstances, a partner will recognize loss on a distribution in liquidation of the partner's interest if no property other than money and unrealized receivables is distributed the partner.[130]

A partner may recognize gain or loss on a distribution of property that was contributed to the partnership by the partner within seven years of the distribution.[131]

If the partner receives an in-kind distribution from the partnership (other than a liquidating distribution), the partner's basis in the property received equals the property's adjusted basis in the hands of the partnership immediately before the distribution (but not in
excess of the partner's basis in his or her partnership interest), less any money distributed in the same transaction.[132] A partner's basis in in-kind property distributed as part of a liquidating distribution is the same as his or her basis in the partnership, reduced by money distributed to him or her in the same transaction.[133]

Important Note: Special rules apply to disproportionate distributions of partnership assets that include unrealized receivables (as defined in I.R.C. § 751(c)) and substantially appreciated inventory (as determined by Code § 751(b)(3)(A) and (d)). Disproportionate distributions of these assets are not treated as distributions, but as a sale or exchange of assets. Both the partnership and the partners may have income, gain, or loss as a result of proportionate distributions.

(2) Partnership Tax Consequences

No gain or loss is recognized to a partnership on a distribution of property or money to a partner.[134] The one exception is for disproportionate distributions, which are treated as a sale or exchange by the partnership.

Comparison to Corporations: Because no gain or loss is recognized on a distribution of money or property to a partner, partners are able to defer recognition of the gain in the appreciated property. In contrast, distributions of appreciated property by C

[129] I.R.C. § 731(a)(1), 731(c)(1)(A).
[130] I.R.C. § 731(a)(2).
[131] I.R.C. §§ 704(c)(1)(B), 737.
[132] I.R.C. § 732(a).
[133] I.R.C. § 732(b).
[134] I.R.C. § 731(b).

corporations and S corporations are treated as though the property were sold to the shareholder at fair market value.[135]

For S corporations, this deemed sale results in gain recognized by the S corporation, which is passed through to the shareholders and increases their basis in the S corporation stock.[136] The distribution then reduces the shareholder's basis.[137] Assuming the S corporation has no accumulated earnings and profits, the shareholder will have no gain on the later distribution except to the extent that the amount of the distribution exceeds his or her adjusted basis in the stock.[138]

(d) Tax Consequences of Sale or Liquidation

A partner may withdraw from a partnership by either sale or liquidation of his or her partnership interest. A partner's sale of his or her partnership interest is taxable. The seller-partner will recognize ordinary income to the extent that the gain from the sale of his or her partnership interest is attributable to unrealized receivables and inventory.[139] The seller-partner's capital gain or loss equals the difference between the amount the partner realizes in the sale (reduced by the portion attributable to unrealized receivables and inventory) and the seller- partner's adjusted basis in his or her partnership interest (also reduced by the portion attributable to unrealized receivables and inventory).[140]

The buyer of the partnership interest will have a cost basis.[141] By default, the buyer-partner will inherit the selling-partner's capital account.[142] Because partnership assets may have appreciated or depreciated in value, this usually results in a disparity between the buyer-partner's basis in his or her partnership interest (outside basis) and his or her allocation of the partnership's basis in each of the assets owned by the partnership (inside basis). To resolve this disparity,
I.R.C. § 754 allows the partnership to make special basis adjustments to the inside basis of the partnership assets.

The liquidation of a partner's interest may represent his or her interest in the fair market value of the partnership's assets, his or her interest in unrealized receivables, or guaranteed payments for his or her interest.

To the extent that the payment represents the partner's interest in the fair market value of the partnership's assets, it is treated as a distribution to the partner under the normal distribution rules.[143]

[135] I.R.C. § 311(a), (b).
[136] I.R.C. § 1367(a)(1).
[137] I.R.C. § 1367(a)(2).
[138] I.R.C. § 1368(b).
[139] I.R.C. §§ 741, 751(a).
[140] Treas. Reg. § 1.741-1(a).
[141] I.R.C. §§ 742, 1012.
[142] Treas. Reg. § 1.704-1(b)(2)(iv)(l).
[143] I.R.C. § 736(b).

To the extent that the payment represents the partner's interest in unrealized receivables, the partner will have ordinary income or loss.[144]

To the extent that the payment is a guaranteed payment, it is governed by the rules applicable to guaranteed payments under I.R.C. § 707(c).[145]

A partnership is ordinarily treated as terminating for tax purposes (regardless of whether it actually terminates) if it stops doing business as a partnership or if 50% or more of the total interest in partnership capital and profits changes hands by sale or exchange within 12 consecutive months.[146] Contributions of property in exchange for partnerships and gifts, bequests, inheritances, and liquidations are not counted for purposes of this 50% test, even if the result is more than a 50% change.[147]

(e) Restrictions on Ownership

Unlike S corporations, ownership of partnerships and limited liability companies is generally unlimited. There are no restrictions on who may be a partner or on how many persons or entities may be members of a single partnership.

(f) Restrictions on Capital Structure

Compared to S corporations, partnerships have more flexibility to allocate profits, losses, and credits among the owners. Because of the *one class of stock* requirement, all S corporation distributions must be *pro rata* among the shareholders. Partnerships may make unequal distributions and allocations (as long as the allocations have substantial economic effect, as explained above).

(g) Adjustments to Basis

Under the default rules, a partnership's basis in partnership assets is not affected by distributions to the partners or transfers of partnership interests. But unlike corporate tax law, the Internal Revenue Code allows the partnership to adjust the tax basis of partnership assets if the partnership makes an election under I.R.C. § 754 (754 election). A partnership can make a 754 election when there is a *substantial basis reduction* resulting from a distribution[148] or if there is a transfer of partnership interest by reason of sale or exchange or death of a partner.[149] Once the election is in place, it applies to all applicable transfers and can be revoked only with the consent of the district director for the district where the partnership's tax returns are filed.

Important Note: A 754 election (and corresponding basis adjustment) is not allowed for the transfer of property by gift.

[144] I.R.C. §§ 741, 751(a).
[145] I.R.C. § 736(a)(2).
[146] I.R.C. § 708.
[147] Treas. Reg. § 1.701-1(b)(2).
[148] I.R.C. § 734(a).
[149] Treas. Reg. § 1.754-1(b).

A 754 election will allow the partnership to adjust a partner's share of the basis of the partnership assets (inside basis) to equal the partner's basis in his or her partnership interest (outside basis). It does so by triggering two provisions: I.R.C. § 734(b) and I.R.C. § 743(b).

I.R.C. § 734(b) applies to distributions that result in gain or loss recognition under I.R.C. § 731(a) or distributions that change the tax basis of an asset under I.R.C. § 732. I.R.C. § 743(b) applies on to the sale or exchange of a partnership interest or the death of a partner. It makes an adjustment equal to the difference between the recipient partner's basis (cost basis if acquired by sale or exchange, stepped-up basis if inherited) and the recipient partner's share of the partnership's adjusted basis of partnership property.[150] This adjustment is prorated across the partnership assets.[151]

Important Note: Even if the partnership has not made a 744 election, I.R.C. 743(b) adjustments must be made to the basis of partnership assets if, immediately after the transfer of a partnership interest, there is a *substantial built- in loss*.[152]

(h) Valuation Discounts

For estate, gift, and generation-skipping transfer tax purposes, the transfer of a partnership interest can be transferred at a lower value than could a pro-rata portion of the assets owned by the partnership. In the estate planning context, this allows partnership assets to be transferred to the next generation at a lower tax cost than if the assets were not held in a partnership. The amount of the valuation discount depends on the percentage of partnership interest being transferred and restrictions imposed under state law. Common discounts include a discount for lack of marketability and a discount for lack of control (minority discount).

> **Discount for Lack of Marketability** – State law generally imposes restrictions on the transferability of partnership interests without the consent of the partners. This can help support a discount for lack of marketability. This discount is enhanced if there is no provision in the partnership agreement requiring distributions to pay the income tax attributable to the limited partnership interests. This creates a situation where the limited partner is taxed on income earned by the partnership without any corresponding offset in income to pay the tax.
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> **Discount for Lack of Control** – The value of limited (noncontrolling) partnerships interests are discounted to reflect the fact that limited partners cannot control the affairs of the partnership. This makes the limited partnership interests less desirable to a willing buyer.

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[150] Treas. Reg. § 1.743-1.
[151] *See* I.R.C. § 755.
[152] I.R.C. § 743(d).

Partnerships generally provide the most compelling cases for valuation discounts. State law generally imposes restrictions on transferability and limited partner withdrawal rights, and federal law taxes the partners on income earned by the partnership, regardless of whether income is actually distributed. This can result in significant discounts to the value of the partnership interest compared to the underlying partnership assets. These discounts are best leveraged when the partnership is formed in a jurisdiction that imposes clear state law restrictions on liquidations and withdrawal rights of limited partners. The partnership agreement should also provide that voting and liquidation rights do not lapse upon transfer of a partnership interest.

(i) Employment Taxes

Partners are subject to self-employment tax on their distributive shares of the ordinary income of the partnership (unless they come within the limited partner exemption of I.R.C. § 1402(a)(13)). Limited liabilities that are taxed as partnerships can avoid this treatment by electing to be treated as a corporation, then electing to be treated as a Subchapter S corporation for tax purposes. But, as with corporate forms, the limited liability company would be required to pay an appropriate salary that would be subject to Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) withholding. Electing Subchapter S treatment may also be impractical due to the loss of flexibility required by the rules governing S corporations.

An alternative strategy is to form a C corporation or S corporation to hold the general partnership interest in a limited partnership. The owners that provide services would do so as employees of the corporate general partner. Compensation for services rendered to the corporate general partner would be subject to self-employment tax; distributions from the partnership to them as limited partners would not. But, as always, the compensation paid to the owner- employees must be reasonable in light of the services provided.

(j) Fringe Benefits

Partners of partnerships (and members of limited liability companies) can take advantage of fewer tax-favored fringe benefits than they could as employees of C corporations. Fringe benefits available to partners include:

> **Working Condition Fringe Benefits** – A working condition fringe benefit is any property or service provided to an employee to the extent that, if the employee had paid for the property or service, the payment would have been deductible under I.R.C. §§ 162 or 167 as a business expense. Tax-free working condition fringe benefits include business-related use of an automobile, business-related use of country club dues paid by the partnership, job-related education expenses, and job-placement assistance.
>
> ***De Minimis* Fringe Benefits** – Partners may receive *de minimi*s fringe benefits, such as tax-free meals (supper money) and local transportation fare for overtime work, traditional birthday and

holiday gifts with low value, occasional tickets to recreational events, and traditional gifts for length of service.

Dependent Care Assistance – A partner may receive tax free any amounts provided under a written plan of the partnership- employer, up to $2,500 annually ($5,000 for a married person).

Educational Assistance Programs – Partners may take advantage of employer-provided educational assistance up to the applicable limits, regardless of whether it is job related.

Use of On-Premises Athletic Facilities – Partners and their spouses and children may use on-premises athletic facilities.

(k) State-Level Franchise Tax Issues

Although a full discussion of state law tax consequences of choice of entity is beyond the scope of this guide, capital-based franchise taxes should be given careful consideration when choosing a corporate entity. In many states, corporations are subject to franchise tax, making the corporate form more costly than other alternatives, such as limited liability companies. This makes partnerships or limited liability companies more desirable from a franchise-tax perspective. Consideration of this issue at the time of formation can prevent detrimental tax consequences that could arise if the organization later decides to convert to limited liability company status.

Update: ATRA's Impact on Choice-of-Entity Decisions

The American Taxpayer Relief Act of 2012[153] (ATRA) returned the top individual tax rate to 39.6% (not counting the new 3.8% Medicare tax[154]), but left the top corporate income tax rate at 35%. This update discusses how the disparity between the top corporate income tax rate and the top individual income tax rate may affect the choice-of-entity decision.

Income Tax Rates for Pass-Through Entities

As discussed above in the Tax Considerations section of this Choice-of-Entity Decision Guide, S corporations, partnerships, and LLCs taxed as partnerships (*pass-through entities*) are all subject to a single level of tax. The owner of a pass-through entity pays tax on his or her share of the entity's income at his or her individual income tax rate. There is no tax when distributions are made from a pass-through entity to its owner.

Under this system, the tax rate for the operating income of the pass-through entity will be the tax rate of the owner of the pass-through entity. If the owner of a pass-through entity is in the top individual tax bracket, the owner's share of operating income will be subject to a 39.6% income tax, plus an additional 3.8% for income subject to the Medicare tax. As a result, the effective tax rate on operating income earned by pass-through entities can be as high as 43.4% for ordinary income and 23.8% for capital gains and dividends.

Income Tax Rates for C Corporations

Income earned by C corporations—and LLCs taxed as C corporations—is taxed twice: once at the corporate level when the income is earned and again when distributions are made to shareholders.

At the corporate level, the top income tax rate remains at its pre-ATRA level of 35%. This means that the top C corporation rate for operating income is 4.6% lower than the top rate that applies to owners of pass-through entities. Since the Medicare tax does not apply to C corporations, passive owners can save another 3.8% in Medicare taxes by using an entity taxed as a C corporation.

Impact on Choice-of-Entity Decision

As long as no earnings are distributed, the lower entity-level tax rates that apply to C corporations may seem appealing. But the lower corporate tax must be balanced against the tax cost of distributions to the owners. Pass-through entities with owners in the top tax bracket may

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[153] Pub.L. 112–240, 126 Stat. 2313 (Jan. 2, 2013) (http://www.gpo.gov/fdsys/pkg/PLAW-112publ240/pdf/PLAW-112publ240.pdf).

[154] The Medicare 3.8% tax applies to "net investment income" earned by unincorporated taxpayers (individuals, estates, and certain trusts) with modified adjusted gross income in excess of certain threshold amounts. For individuals, the threshold amounts are $250,000 for married taxpayers filing a joint return or surviving spouses, $125,000 for married taxpayers filing separately, and $200,000 for other taxpayers. The threshold for estates and trusts is equal to the highest amount at which the maximum tax rate begins. Dividends, capital gains, rents, and royalties are all subject to the tax unless earned in the ordinary course of a trade or business that is not a passive investment.

pay a higher initial income tax, but later distributions to the owners are tax-free. Conversely, C corporations may pay a lower tax on operating income, but owners will be taxed again when the income is distributed. The second level of tax that applies to C corporations—namely on distributions to their shareholders—will generally more than offset the up-front tax savings offered by the lower corporate tax rates.

In addition, a pass-through entity is usually the preferred choice of entity for selling a business. Asset sales allow buyers to adjust or "step up" their basis in the assets to fair market value and leave unknown liabilities with the seller. Because of this advantage, most buyers prefer to acquire the assets of a business instead of the equity interests. The ability to structure a transaction as an asset sale can therefore allow the seller to negotiate a higher price.

Although asset sales can be structured regardless of whether the seller is classified as a C corporation or a pass-through entity, the tax consequences to the seller can differ significantly. The sale of assets by a C corporation will trigger an entity-level tax at the corporation's tax rate, followed by an ownership-level tax when the proceeds from the sale are distributed to the shareholders. In contrast, a properly structured sale of the assets of a pass-through entity can provide the seller with capital gains treatment on the sale proceeds and avoid the second, owner- level tax on liquidation.

In summary, the tax cost of double taxation will usually outweigh the short-term tax savings resulting from a lower corporate income tax rate. Stated differently, the lack of double taxation for pass-through entities will usually outweigh the top income tax rate differential between pass- through entities and C corporations. Unless the owners plan never to take a dividend or sell assets, pass-through entities generally remain the most tax-efficient choice for most businesses.