2006

Tax Considerations of Transfers to and Distributions from the C or S Corporation

C. Wells Hall III

TAX CONSIDERATIONS OF TRANSFERS TO AND DISTRIBUTIONS FROM THE C OR S CORPORATION

C. Wells Hall, III
Mayer, Brown, Rowe & Maw LLP
Charlotte, North Carolina

The College of William & Mary
52nd Tax Conference
Williamsburg, Virginia

November 16 and 17, 2006

TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

Page

TABLE OF CONTENTS
(continued)

Page

TAX CONSIDERATIONS OF TRANSFERS TO AND DISTRIBUTIONS FROM THE C OR S CORPORATION

C. Wells Hall, III
Mayer, Brown, Rowe & Maw LLP
Charlotte, North Carolina

The College of William & Mary
52nd Tax Conference
Williamsburg, Virginia

November 16 and 17, 2006

I. Overview.

The taxable income of an entity classified as an association taxable as a corporation under Subchapter C of the Internal Revenue Code, as amended (the "Code")[1] is subject to tax at the graduated rates listed in section 11 of the Code. In addition to the entity level tax, distributions of cash and other property to the shareholders are subject to tax at the shareholder level.

A C corporation may avoid the corporate level tax on earnings by electing to be taxed under Subchapter S of the Code. The earnings of an S corporation are generally subject to only one level of tax at the shareholder level. S corporations are subject to special limitations on the number and type of shareholders. For example, a corporation or institutional investor may not be a shareholder in an S corporation because Subchapter S of the Code only permits individuals and certain trusts to be S corporation shareholders. While the number of shareholders of an S corporation is limited to 100, a special family attribution rule permits members of a family up through six generations from a common ancestor to be treated as one shareholder.[2]

The C corporation is a flexible form of business entity recognized in all 50 states and under most foreign laws. In addition, a limited liability company organized under state law may elect to be taxed as a corporation. Other than the restrictions on the election to be taxed under Subchapter S, there are no limitations on ownership, activities or financing of corporations, other than federal and securities and regulatory laws. Since a corporation subject to tax under Subchapter S is also subject to Subchapter C, many of the issues considered in selecting the C corporation as the choice of entity are also relevant in selecting the S corporation, including the tax consequences of transferring property and liabilities to a corporation. There are also similarities, as well as substantial differences, in the treatment of distributions from a corporation taxed as a C corporation and a corporation taxed as an S corporation.

---

[1] Unless otherwise specified, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §," Reg. §, or "Regulation" references are to the Treasury regulations promulgated thereunder.

[2] Section 1361(c)(1)(A) and (B).

II. Tax Treatment of Transfers of Property and Liabilities to a Corporation

A. *Non-Recognition of Gain and Loss*

Under general tax principles, when a taxpayer disposes of property, gain or loss is recognized, measured by the difference between the fair market value of what the taxpayer receives in the exchange and the basis in the disposed property. However, section 351 overrides such principles by providing that shareholders do not recognize gain or loss on certain transfers of property to a controlled corporation in exchange solely for stock. At the corporate level, section 1032(a) provides that the corporation does not recognize gain or loss when it receives money or other property in exchange for its stock. The rationale is that these transactions merely change the form of the shareholders' investment and are, thus, not appropriate events for taxation. The specific requirements of section 351 are: (1) one or more persons must transfer "property" to a corporation; (2) the property must be transferred solely in exchange for "stock" of the corporation; and (3) the transferors, as a group, must be in "control" of the corporation "immediately after the exchange." Each of these statutory elements is discussed below.

1. *Property*

"Property" includes cash, accounts receivable, inventory, patents and such other intangibles as goodwill and industrial know-how. Property does not include services.[3] Thus, if the new corporation issues more than 20% of stock in return for past, present or future services rendered, the issuance will take the entire transaction (including issuances of stock to the other shareholders for property) out of the ambit of section 351, making the transaction taxable. However, if a person receives stock for both property and services, he is generally considered a transferor of property and may count all the stock he received for purposes of the control test (below), unless: (1) the value of the property transferred is relatively small compared to the value of the stock received for services, and (2) the primary purpose of the property transfer is to qualify the exchanges of other transferors for non-recognition.[4] The IRS does not consider property "of relatively small value" if its value equals 10% or more of the value of the stock received for services.[5]

2. *Transfer*

All substantial rights in the property must be transferred to the corporation. A limited license of property (e.g., non-exclusive license to use technology) does not satisfy the "transfer" requirement, and any stock received for the license is treated as royalty income.

3. *Stock*

Only stock in the corporation may be issued under the section 351 non-recognition regime. Issuances of stock rights, warrants, and convertible debt securities are not included.[6]

---

3 Section 351(d)(1); Reg. § 1.351-1(a)(1)(i).
4 Reg. § 1.351-1(a)(1)(ii).
5 Rev. Proc. 77-37, 1977-2 C.B. 568.
6 Reg. § 1.351-1(a)(1).

4. *Control*

The transferors of the property to the corporation are considered in "control" of the corporation if they, as a group, own at least (A) 80% of the combined voting power of all classes of stock entitled to vote, and (B) 80% of each class of nonvoting stock.[7] It is permissible for some transferors to receive voting stock while others receive nonvoting stock. Non-simultaneous transfers are also permitted so long as the rights of the transferors have been previously defined and the agreement proceeds with an "expedition consistent with orderly procedure."[8]

5. *Immediately After the Exchange*

When a transferor disposes of his stock shortly after issuance by the corporation in exchange for his property, there is a risk that the transferors, as a group, will fail the 80% control test if it is determined that the test should be applied after the disposition. Specifically, where a transferor disposes of the stock pursuant to a prearranged binding agreement that he entered into prior to the section 351 exchange, the control test is applied after the disposition. In such a case, a disposition of either (A) more than 20% of voting stock or (B) 20% of any class of nonvoting stock will disqualify the entire transaction.[9] A disposition by gift will not cause a transaction to fail the "immediately after" test.[10]

B. *Shareholder's Basis in Stock*

If the transaction qualifies under section 351, the shareholder's basis in the stock received in exchange for property will equal: (A) the shareholder's basis in the property transferred to the corporation (determined immediately before the transfer), less (B) any of the shareholder's liabilities assumed by the corporation, less (C) cash and other non-stock property the shareholder received from the corporation ("boot"), increased by (D) any gain the shareholder recognized as a result of the boot (as discussed below).[11] If the shareholder received more than one class of stock, the foregoing basis is allocated among the classes of stock in proportion to the fair market value of each class.[12]

C. *Shareholder's Holding Period in Stock*

The shareholder's holding period in stock received in exchange for a capital asset or section 1231 property includes the holding period of the transferred property.[13] The holding period of stock received in exchange for an ordinary income asset (e.g., inventory or accounts receivable) begins on the date of the exchange. If stock is received for a combination of both

---

7 Section 368(c).

8 Reg. §1.351-1(a)(1).

9 *See Intermountain Lumber Co. v. Commissioner,* 65 T.C. 1025 (1976).

10 *See Wilgard Realty Co. v. Commissioner,* 127 F.2d 514 (2nd Cir. 1942), cert. denied, 317 U.S. 655 (1942).

11 Sections 358(a)(1); 358(d).

12 Section 358(a)(1); Reg. § 1.358-2(a)(2).

13 Section 1223(1).

capital and ordinary income property, each share of stock takes a split holding period, allocated in proportion to the fair market value of the transferred property.[14]

D. *Corporation's Basis and Holding Period in Transferred Property*

The corporation's basis in the transferred property is the same as the transferor's basis, increased by any gain the transferor recognized on account of boot.[15] The corporation's holding period includes the transferor's holding period, regardless of whether the transferred property was a capital asset or section 1231 property in the transferor's hands.[16]

E. *Boot*

If a shareholder received boot, the shareholder must recognize gain (but not loss) to the extent of the fair market value of the boot.[17] When several properties are transferred in exchange for a combination of stock and boot, the boot must be allocated among the transferred properties in proportion to the fair market values of each, and any boot allocated to a loss property will not cause a recognition of gain or loss.[18] If the corporation transfers an appreciated asset to a shareholder as boot, the corporation is required to recognize gain on the transfer as if it had distributed the asset in a section 311(b) transaction (shareholder distribution).[19]

F. *Liabilities*

If the corporation assumes a liability of the transferor or takes the transferred property subject to a liability in a section 351 exchange, the liability is generally not treated as boot to the shareholder.[20] However, the liability relief is boot if the liability was transferred to the corporation for the purpose of avoiding federal income tax.[21] In addition, if the liability relief exceeds the aggregate bases of the transferred properties by a particular transferor (i.e., debt in excess of basis), the excess is treated as gain from the sale or exchange of property.[22]

G. *Depreciation Recapture*

Section 351(a) also overrides the depreciation recapture provisions (except where the transferor must recognize gain as result of receipt of boot). The potential recapture gain is preserved in the transferee corporation's basis in the transferred property.[23] Also, a transferor who transfers an installment note to the corporation in a section 351 exchange is not required to

---

14 Rev. Rul. 85-164, 1985-2 C.B. 117.
15 Section 362(a).
16 Section 1223(2).
17 Section 351(b).
18 Rev. Rul. 68-55, 1968-1 C.B. 140.
19 Section 351(f).
20 Section 357(a).
21 Section 357(b).
22 Section 357(c)(1).
23 Sections 1245(b)(3); 1250(d)(3).

recognize gain (if any) on the transfer.[24] The tax consequences of the installment note in the transferor's hands carry over to the transferee corporation.

H. *Transfers to Investment Companies*

Transfers to a corporation equivalent to an "investment company" as defined in section 351 do not qualify for non-recognition. The purpose of this rule is to prevent tax-free diversification by transferring appreciated portfolios of securities in exchange for stock of a newly formed investment company.[25] Generally, a contribution to a corporation will be considered to be made to an investment company if (a) the transfer results in diversification of the transferor's assets under a mechanical "diversification" test in the Code, and (b) more than 80% of the partnership's assets are stocks or securities held for investment.[26]

III. Tax Treatment of Distributions from a Corporation to its Shareholders

A. *Tax Treatment of Distributions From a C Corporation*

1. *Taxation of Qualifying Dividends Under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGA-2003)*

(a) After the amendments to the Code by JGA-2003 (effective January 1, 2003), the term "qualifying dividend income" means dividends received during the taxable year from domestic corporations and qualified foreign corporations received by a non-corporate taxpayer (i.e., a taxpayer whose capital gain income is subject to section 1(h).[27] The tax rate on "qualifying dividends" received by taxpayers between January 1, 2003 and December 31, 2008 is set at a maximum of 15% (5% for low income taxpayers).

(b) Such term does not include:

(1) Any dividend from a tax-exempt corporation.[28]

(2) Any tax deductible dividend paid by a mutual savings bank.[29]

(3) Any deductible dividend paid by a C corporation with respect to employer securities in a qualified plan that is paid to a plan participant.[30]

---

24 Reg. § 1.453-9(c)(2).

25 Section 351(e); Reg. § 1.351-1(c).

26 Section 351(e)(1)(B) lists the following assets that are treated as stocks and securities (1) money (contrary to the Regulations which have not been updated); (2) stocks, options, forward or futures contracts, notional principal contracts and derivatives, (3) foreign currency, (4) interests in real estate investments trusts, common trust funds, regulated investment companies, publicly traded partnerships, (5) interests in precious metals, (6) interests in any entity if substantially all of its assets include the foregoing, and (7) any other assets specified in the Regulations.

27 Section 1(h)(11)(B)(i)(I) and (II).

28 *See* sections 501 and 521. Section 1(h)(11)(B)(ii)(I).

29 *See* section 591. Section 1(h)(11)(ii)(II).

30 *See* section 404(k). Section 1(h)(11)(B)(ii)(III).

(4) Any dividend paid with respect to stock held by the shareholder for less than 60 days during the 120-day period beginning 60 days before and ending 60 days after the ex-dividend date.[31]

(5) Any dividend paid by a RIC or REIT to the extent deductible in computing the table income of such entity.[32]

(c) If the taxpayer receives any dividends that constitute extraordinary dividends on stock under section 1059(c), any loss on the sale or exchange of such stock shall, to the extent of such dividends, be treated as long-term capital loss. Generally, an extraordinary dividend on preferred stock exceeds 5% of the shareholder's adjusted basis, and on common stock, 10% of the shareholder's stock basis.

(d) Qualifying dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B).

2. *Actual Distributions*

For purposes of Subchapter C, a "distribution" is any kind of payment (e.g., cash, stock in the corporation or other property) by a corporation to its shareholders in connection with their stock. A dividend is a distribution out of the corporation's current or accumulated earnings and profits ("E&P").

3. *Constructive Distributions*

In addition to outright distributions of cash and other property to its shareholders, a corporation may transfer cash or other property to (or make the same available for use by) one or more of its shareholders without characterizing the transfers as distributions. Such transactions may be reclassified as constructive distributions to the shareholders if the facts and circumstances surrounding such transactions give rise to a determination that the corporation was merely attempting to avoid the double tax by not formally labeling the transaction as a distribution. As with actual dividends, there must be either current or accumulated E&P in order for there to be a constructive dividend. Following are some examples of constructive distributions.

---

31 Section 1(h)(11)(B)(iii).

32 Section 1(h)(11)(D)(iii).

(a) *Unreasonable Compensation*

If the corporation pays a shareholder (or the shareholder's relative) who is also an employee of the corporation more than reasonable compensation, the excess is treated as a dividend with the consequence that the corporation may not deduct such excess as a business expense. The employee is required to include the full amount in his gross income in any case. Note that the failure of a closely-held corporation to pay dividends is a significant (but not conclusive) factor in determining whether compensation paid to a shareholder-employee is unreasonable.[33]

(b) *Bargain Sales/Leases To Shareholder*

If the corporation sells or leases property to a shareholder at below market rates, the fair market value of the property (or fair market rents) minus the amount paid by the shareholder constitutes constructive dividends.

(c) *Excessive Sales/Leases to Corporation*

On the flip side, where the corporation pays more than market rates to purchase or rent property from a shareholder, the excess amounts constitute constructive dividends.

(d) *Shareholder's Personal Expenses*

Corporate payments of expenses that provide only incidental or no benefits to the corporation may be reclassified as dividends.

(e) *Payment on Reclassified Debts*

If a shareholder's debt to the corporation is reclassified as equity, corporate payments of interest and principal on such "debt" are treated as dividends.

(f) *Corporate Low Interest Loans*

If the corporation lends money to a shareholder at below market interest rates, the foregone interest is treated as dividends to the shareholder (followed by a deemed payment of the same amount to the corporation as interest).[34]

(g) *Corporate Loans Without Payment Expectation*

If a corporate loan is made to a shareholder without an expectation of repayment, the entire amount (principal plus foregone interest) may constitute a constructive dividend.

4. *Dividends vs. Capital Gain Treatment*

A three-prong test is applied in assessing the tax treatment of distributions – determining the distribution amount, determining how much of the distributed amount constitutes a dividend,

---

33 Rev. Rul. 79-8, 1979-1 C.B. 92.

34 Section 7872.

and ascertaining whether the remaining amount is a recovery of capital and/or capital gain. Under JGA-2003, the effective tax rate on qualifying dividends and long term capital gains is limited to 15 percent.

(a) *Amount of the Distribution*

The amount of the distribution is the amount of cash distributed to the shareholder. In the case of property other than cash, the distribution amount is the fair market value of the property reduced by any liability to which the property is subject.

(b) *Dividend Treatment*

The amount of the distribution is a dividend to the shareholder to the extent the corporation has sufficient current or accumulated E&P.[35] The approach is to look to current E&P as of the end of the year without reduction by distributions made during the year, and then, if necessary, to the most recent accumulated E&P. If current E&P as of the end of the year exceeds the amounts of distributions made during the year, all such distributions are dividends and any excess E&P is added to the accumulated E&P account.[36] On the other hand, if the distribution amounts exceed current E&P, the portion of each distribution that is treated as coming out of current E&P is determined as follows: (amount of each distribution) divided by (total distributions) and multiplied by (current E&P). Thereafter, the remainder of each distribution is a dividend to the extent of the accumulated E&P on the date of the distribution. If there are no current E&P (or if there is a deficit in the current E&P account), but the corporation has accumulated E&P as of the beginning of the year, the amount of a distribution constitutes a dividend to the extent of the accumulated E&P reduced by that portion of the current E&P deficit that is allocable to the period prior to distribution. Unless the deficit can be traced to a particular time of the year, it must be prorated on a daily basis to the date of the distribution.[37] If any portion of the distribution amount constitutes a dividend, the shareholder must include that portion in his gross income.[38]

(c) *Recovery of Capital*

The portion of a distribution amount that is not a dividend (because it exceeds both current and accumulated E&P) is treated as a recovery of the shareholder's capital that reduces his basis in the stock.

(d) *Gain Treatment*

Any portion of the distribution amount remaining after being treated as a dividend and/or capital recovery, is treated as a gain from a sale or exchange of the shareholder's stock.[39]

---

35 Section 316(a); Reg. § 1.316-2(a).
36 Reg. § 1.316-2(b).
37 Reg. § 1.316-2(b); Rev. Rul. 74-164, 1974 C.B. 74.
38 Sections 61(a)(7); 301(c)(1).
39 Section 301(c)(3).

5. *Redemptions and Distributions Treated as Exchanges*

A shareholder receiving a distribution from the corporation may avoid dividend treatment altogether if the distribution is made in redemption of his stock whereby: (I) his equity interest in the corporation is significantly reduced (as discussed in (a), (b) or (c) below), or (II) there is a meaningful contraction of the corporation's business activities (as discussed in (d) below). If the transaction qualifies under any of the following tests, it is treated as an "exchange" of stock for a corporate distribution and the shareholder may be entitled to capital treatment on all or part of the distribution amount.

(a) *Substantially Disproportionate Redemptions*

Under this test, a distribution in redemption is treated as an exchange if: (A) immediately after the redemption, the shareholder owns less than 50% of the total combined voting power of all classes of stock entitled to vote; (B) the percentage of voting stock owned by the shareholder immediately after the redemption is less than 80% of the percentage of voting stock owned by him immediately before the redemption; and (C) the percentage of common stock (whether or not voting) owned by the shareholder immediately after the redemption is less than 80% of the percentage of common stock he owned immediately before the redemption.[40] Notwithstanding a shareholder's meeting the foregoing requirements with respect to a distribution, exchange treatment is denied if such distribution is made pursuant to a plan having the purpose or effect of a series of distributions that, taken together, result in no significant reduction of the shareholder's equity interest in the corporation.[41]

(b) *Complete Termination of a Shareholder's Interest*

A redemption is treated as an exchange if it completely terminates the shareholder's actual and constructive stock interests in the corporation.[42] A complete termination of a shareholder's actual interest in the corporation will qualify for exchange treatment even if he constructively owns stock of a family member under the attribution rules, so long as all of the following requirements are met: (A) the shareholder has no interest in the corporation immediately after the redemption as a shareholder, director, officer, employee or independent contractor; (B) the shareholder does not acquire any of the forbidden interests (other than stock acquired by inheritance of bequest) during the 10-year period beginning on the date of the redemption; (C) the shareholder attaches a statement to his income tax return for the year of redemption stating that he has not acquired any forbidden interest since the redemption and that he agrees to notify the Internal Revenue Service ("IRS") of any such acquisition during the 10-year period within 30 days after it occurs; (D) the shareholder did not acquire any portion of the redeemed stock within the 10-year period preceding the redemption from a person whose stock is attributable to him under the family attribution rules; and (E) at the time of the redemption no person owns stock that is attributable to the shareholder under the family attribution rules if that person acquired any stock from the shareholder within the 10-year look-back period. Note that requirements D and E need not be met if the acquisition or disposition by the shareholder during

---

40 Section 302(b)(2).

41 Reg. § 1.302-3(a).

42 Section 302(b)(3).

the 10-year look back period was not principally motivated by a tax avoidance purpose.[43] Under section 318(a)(1), a person is treated as owning constructively stock held directly by that person's (i) spouse (other than a spouse who is legally separated under a decree of divorce or separate maintenance), (ii) children, (iii) grandchildren, and (iv) parents.

(c) *Redemptions Not Essentially Equivalent to a Dividend*

A redemption is also accorded exchange treatment if facts and circumstances demonstrate that the redemption resulted in a "meaningful reduction of the shareholder's proportionate interest in the corporation."[44] The family attribution rules also apply here. However, a business purpose or lack of tax avoidance motive in connection with the redemption is irrelevant under this test. The IRS has considered the following shareholder rights in determining whether there has been a meaningful reduction: (A) voting, (B) participation in current earnings and corporate growth, and (C) sharing in net assets on liquidation.[45] Using these factors, the IRS has found a meaningful reduction in the following situations:

> (1) A reduction of voting rights from 57% to 50%, where the remaining shares are held by one unrelated shareholder.[46]
>
> (2) A reduction of a minority shareholder's common stock holding from 30% to 24.3%.[47]
>
> (3) A reduction of common stock holding from 27% to 22%, where the remaining shares are owned by three unrelated shareholders (on the ground that the shareholder lost the power to control the corporation in concert with one of the other shareholders).[48]

(d) *Partial Liquidations*

When the corporation significantly contracts its business and makes a related distribution to its shareholders in redemption of all or part of their stock, the redemption qualifies for exchange treatment. Corporate shareholders do not qualify under this test. A distribution satisfies this test if: (A) it is made pursuant to a plan; (B) it occurs within the taxable year in which the plan is adopted or the succeeding taxable year; and (C) either the distribution is attributable to the termination of a qualified trade or business and immediately after the distribution, the corporation continues to engage in the conduct of another qualified trade or business, or the distribution results from a contraction of the corporation's business.[49] A qualified trade or business is any trade or business that the corporation actively and directly engaged in during the five-year period preceding the distribution date, so long as the corporation did not acquire such trade or business in a taxable transaction during the same five-year period.

---

43 Section 311(c)(2)(B).
44 *See U.S. v. Davis,* 397 U.S. 301 (1970).
45 Rev. Rul. 81-289, 1981-2 C.B. 82.
46 Rev. Rul. 75-502, 1975-2 C.B. 111.
47 Rev. Rul. 75-512, 1975-2 C.B. 112.
48 Rev. Rul. 76-364, 1976-2 C.B. 91.
49 Section 302(b)(4).

6. *Tax Treatment of C Corporation on Distributions*

(a) *E&P Adjustments*

E&P accounts are maintained solely for purposes of characterizing distributions to shareholders of a C corporation. E&P are determined by starting with taxable income of the corporation and making certain additions, subtractions and adjustments. A brief description of some of these adjustments follows:

> (1) Certain income items that are not taxable income are added back for purposes of calculating E&P. Examples include federal tax refunds, tax-exempt municipal bond interest and life insurance proceeds.[50]
>
> (2) Some tax-deductible items must also be added back to taxable income in calculating E&P. For example, if the corporation itself is a shareholder in another corporation and has taken the "dividends received deduction" under section 243, the deduction must be taken into account for E&P purposes. Another example is the add-back of carryover capital and net operating losses in the year the corporation deducts the losses.
>
> (3) Expenses that are not tax-deductible are subtracted from taxable income in determining E&P. Included in this category are federal income taxes paid, charitable contributions to the extent they exceeded the percentage limitations, and losses incurred by the corporation in a sale or exchange with a related person.
>
> (4) The full amount of gain realized under an installment sale must be included in E&P in the year of sale (even if the corporation is permitted to report the gain in installments when computing its taxable income).
>
> (5) In determining E&P, the corporation must use the straight line method of depreciation of its assets (even though it may use the accelerated cost recovery system in determining its taxable income). As a result of the foregoing, when the subject depreciable asset is sold or otherwise disposed, the amount of gain or loss that must be taken into consideration for E&P purposes needs to be calculated using the adjusted basis of the property that is determined under the straight line method.
>
> (6) Depreciation expense taken under section 179 for taxable income purposes must be amortized ratably over five years for E&P purposes.

7. *Distribution of Non-Cash Assets.*

If the corporation distributes appreciated property to a shareholder, the corporation must recognize gain on the distribution in an amount equal to the property's fair market value less the

---

[50] Reg. § 1.312-6(b).

corporation's basis in the property.[51] If the shareholder assumes or takes the property subject to a corporate liability, the fair market value of the property is treated as not less than the amount of the liability for purposes of determining the corporation's gain.[52] However, where the distributed property is the corporation's own debt obligations, no gain or loss is recognized by the corporation.[53] The corporation may not recognize any loss on a distribution of property to its shareholders.[54]

B. *Tax Treatment of Distribution from an S Corporation*

1. *General Distribution Rules for S Corporations Without Earnings and Profits.*

The same rules governing shareholders in C corporations under section 302 (and 303) also apply to distributions in redemption of stock of an S corporation, including the stock attribution rules in section 318.[55] Characterization of a distribution as a redemption under section 302(a) or as a distribution under section 1368(a) may make little difference to the redeeming shareholder because of the distribution rules governing S corporations having no earnings and profits. Distributions of cash or property made by an S corporation having no accumulated Subchapter C earnings and profits are received tax-free by shareholders to the extent of their basis in the S corporation stock.[56] To the extent distributions exceed basis, however, the excess is treated as gain from the sale or exchange of property.[57] Thus, unless the purchase price is to be paid over a period of years (where the shareholder will need exchange treatment to qualify for the installment sales rules), it essentially makes no difference to the redeeming shareholder whether the transaction is a redemption under section 302(a) or a distribution under section 1368. A separate block rule will apply to non-sale or exchange redemptions in mirroring the results under distributions to shareholders in C corporations.[58]

2. *General Distribution Rules for S Corporations With Earnings and Profits.*

This indifference as to whether a distribution is characterized as a section 302 redemption or a section 1368 distribution *may* also apply to S corporations having earnings and profits. Distributions made by S corporations having accumulated Subchapter C earnings and profits are subject to a 5-tier system of taxation. This system utilizes the corporation's accumulated adjustment account (AAA or "Triple A") in determining the taxability of distributions. AAA generally consists of the accumulated gross income of the S corporation less deductible expenses and prior distributions. The AAA is essentially a running total of the S corporation's income, losses, deductions and distributions. The 5-tier system of taxation may be summarized as follows:

---

51 Section 311(b)(1).

52 Sections 311(b)(2); 336(b) (and the shareholder takes the property with a basis equal to its fair market value without any reduction for liabilities under section 310(d)).

53 Section 311(a).

54 *Id.*

55 *See* sections 1371(a)(1) and 318(a)(5)(E) (S corporation treated as a partnership for entity attribution rules).

56 Section 1368(b)(1).

57 Section 1368(b)(2).

58 *See* Reg. § 1.1367-1(c)(3) and (f).

i. That portion of the distribution that does not exceed AAA is tax-free to the extent of the shareholder's stock basis; [59]

ii. That portion of the distribution that does not exceed AAA, but that does exceed the shareholder's stock basis, is capital gain;[60]

iii. That portion of the distribution that exceeds AAA is a dividend to the extent of the S corporation's accumulated Subchapter C earnings and profits; [61]

iv. That portion of the distribution that exceeds AAA and the accumulated Subchapter C earnings and profits of the S corporation is tax-free to the extent of the shareholder's residual stock basis (the shareholder's adjusted basis in his or her S corporation stock less any reductions made in his or her stock basis for any first-tier distributions); [62] and

v. That portion of the distribution that exceeds AAA, the accumulated Subchapter C earnings and profits of the S corporation, is tax-free to the extent of the shareholder's residual stock basis (the shareholder's adjusted basis in his or her S corporation stock less any reductions made in his or her stock basis for any first-tier distributions).[63]

Thus, even if the redemption is not treated as an exchange, the same result will apply, e.g., return of capital to the extent of basis, gain from the sale of stock to the extent that the amount of the distribution exceeds basis, if the amount received by the shareholder is not in excess of the corporation's AAA as of the close of the taxable year and is allocated among all dividend distributions made during the same period. Where the distribution exceeds AAA as of the close of the taxable year, however, such excess will be a distribution of earnings and profits and taxed as a dividend. The dividend distribution will be allocated pro rata to all distributions made during the year.

3. *Ordering of Adjustments to Basis.*

Before determining the tax treatment of distributions to S corporation shareholders, the basis of the distributee shareholder in his S corporation stock will be increased by items of S corporation income described in section 1367(a)(1), but will *not* be decreased by items of S corporation loss and deduction described in section 1367(a)(2) until after the tax treatment of the distribution has been determined. Additionally, section 1368(e) provides that in determining the corporation's AAA available to cover distributions made during the taxable year, the amount of AAA as of the close of the taxable year will be determined without regard to any "net negative adjustment" (the excess of reductions to AAA for the taxable year over increases to AAA for the taxable year).

---

59 Sections 1368(c)(1) and 1368(b)(1).
60 Sections 1368(c)(1) and 1368(b)(2).
61 Sections 1368(c)(2) and 301.
62 Sections 1368(c)(3) and 1368(b)(1).
63 Sections 1368(c)(3) and 1368(b)(2).

4. *AAA Bypass Election.*

Under section 1368(e)(3), an S corporation which has Subchapter C earnings and profits can make an election to change the ordinary distribution rules discussed above. If a section 1368(e)(3) election (which is referred to as a "AAA bypass election") is made, the distributions from the corporation to its shareholders will first be treated as coming out of the corporation's accumulated Subchapter C earnings and profits to the extent thereof, then out of the corporation's AAA. Because of the 15% tax rate now applicable to dividend distributions, in some situations it may make sense, in order to free up suspended losses and offset other ordinary income of the shareholder, for the corporation to make a section 1368(e)(3) election since such distributions will be taxed at the 15% tax rate and will not reduce the shareholders' stock basis and, as such, allow losses that might otherwise be suspended to flow through and offset other ordinary income of the shareholder which would otherwise be subject to a maximum marginal income tax rate of 35%.

i. *<u>Example - No Section 1368(e)(3)Election</u>*.

1. <u>Facts (Reg. § 1.1368-3 Example (5))</u>:

S is an S corporation with a single shareholder, B. As of 1/1/2005, S has accumulated E&P of $1,000 and AAA of $2,000. On 4/1/2005, S makes a $2,000 distribution to B. For 2005, S has $2,000 of income and $3,500 of deductions. As of 1/1/2005, B owned 100 shares of S stock with a basis of $20 in each share. S does not make an election under section 1368(e)(3) and Reg. § 1.1368-1(f)(2).

2. <u>Analysis</u>:

Under section 1368(e)(1)(C) and Reg. § 1.1368-2(a)(5), in applying adjustments to AAA to determine the taxability of distributions, AAA is determined without regard to any net negative adjustment (excess of reductions in AAA (other than for distributions) over increases in AAA). For purposes of the distribution, the AAA of S is $2,000 ($2,000 + $2,000 (income) $2,000 (loss (not to exceed the 2005 income)). Therefore, the $2,000 distribution to B is out of AAA. The AAA is further reduced by the remaining $1,500 loss to a negative ($1,500). For purposes of determining taxability of the distribution, B's beginning basis of $2,000 is increased by $2,000 income.[64] The $2,000 distribution reduces the basis of B's S stock to $2,000 ($2,000 + $2,000 $2,000). The basis of B's S stock is further reduced by $2,000 of loss. The remaining

[64] Section 1368(d).

$1,500 loss in excess of B's basis in his shares is suspended and will be treated as incurred by S in the succeeding taxable year with respect to B.

3. Summary:

The $2,000 distribution is not taxable to B. B has pass-through of $2,000 income and $2,000 loss. Additionally, B has $1,500 of suspended losses.

ii. *Example - Section 1368(e)(3)Election.*

1. Facts (same as previous example except that S elects under section 1368(e)(3) and Reg. § 1.1368-1(f)(2) to distribute E&P first).

2. Analysis:

The $2,000 distribution by S is deemed to be made first out of accumulated E&P of $1,000 and is a dividend to B.[65] The remaining $1,000 distribution is made out of AAA and constitutes a tax-free return of basis. Under Reg. § 1.1367-1(f):

Beginning basis	$2,000
Increase for income items	2,000
Decrease for distribution not includable in shareholder's income ($2,000 distribution - $1,000 portion treated as dividend)	1,000
Decrease for noncapital, nondeductible expense	-0-
Decrease for items of loss or deduction described in sections 1367(a)(2)(B) and (C) (but not in excess of basis)	(3,000)
Remaining Basis	-0-

The remaining $500 of loss in excess of B's basis in his shares of S stock is suspended and will be treated as incurred by S in the succeeding taxable year with respect to B.

A section 1368(e)(3) election also might be helpful for an S corporation with Subchapter C earnings and profits which wishes to purge such earnings and profits to avoid the

65 *See* Reg. § 1.1368-3 Example (7).

"sting" tax of section 1375 (which applies where the passive investment income of an S corporation having accumulated earnings and profits exceeds 25% of gross receipts) and the possible termination of S corporation status under section 1362(d)(3) (which applies where passive investment income of an S corporation with accumulated earnings and profits exceeds 25% of gross receipts for three (3) consecutive years).

3. Summary:

B has $1,000 dividend income taxed at maximum rate of 15% under section 1(h). B has $2,000 of pass-through income and $3,000 of pass-through loss. Assuming B is taxed at a maximum marginal rate of 35% and loss items are fully deductible by B, he has a net savings of $200 [Excess of ($1,000 x .35) over ($1,000 x .15)].

5. *Allocations of Tax Items.*

Under sections 1366 and 1377(a)(1), the redeemed shareholder will be allocated his or her daily pro rata share of the S corporation's items of income, deduction, loss or credit for the year of the redemption. Where a shareholder completely terminates his or her stock interest, a hypothetical closing of the books rule for allocation purposes can be elected in accordance with section 1377(a)(2).

i. The daily allocation rule of section 1377(a)(1) results in the redeemed shareholder of an S corporation being allocated an amount of the corporation's tax items even *after* the stock is sold.

ii. Under section 1377(a)(2), where a shareholder in an S corporation completely terminates his or her stock interest in the corporation, the corporation and all of the "affected shareholders" may elect hypothetically to close the taxable year of the corporation as of the date of sale in allocating tax items. The "affected shareholders" are the shareholders whose interest ends and all shareholders to whom such shareholder transferred shares during the taxable year.[66] If a shareholder's interest in an S corporation is redeemed by the S corporation, all the shareholders during the taxable year of the redemption are "affected shareholders." If section 1377(a)(2) applies, the pro rata shares of the affected shareholders are determined as if the corporation's taxable year consisted of two taxable years, the first of which ends on the date as of the termination of the shareholder's interest.

1. An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for

---

66 Section 1377(a)(2)(B) and Reg. §1.1377-1(b)(2).

purposes of allocating income (including tax-exempt income), loss, deduction and credit, making adjustments to the accumulated adjustments account, earnings and profits and basis under section 1367, and in determining the tax effect of a distribution to the S corporation's shareholders under section 1368. This comprehensive treatment ensures that full effect is given to treating the taxable year as two separate taxable years, and is consistent with the basis and distribution regulations promulgated under sections 1367 and 1368. An S corporation making a terminating election under section 1377(a)(2) must assign items of income, loss, deduction and credit to each deemed separate taxable year using its normal method of accounting as determined under section 446(a).

2. A terminating election does *not*, however, affect the due date of the S corporation's tax return, nor does a terminating election under section 1377(a)(2) generally affect the taxable year in which a shareholder must take into account his pro rata share of the S corporation's items of income, loss, deduction and credit. If a terminating election is made by an S corporation that is a partner in a partnership, the election will be treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of section 706(c), relating to closing the partnership taxable year, if the taxable year of the partnership ends *after* the shareholder's interest is terminated and *within* the full taxable year of the S corporation for which the terminating election is made. As such, any partnership income earned by an S corporation partner through the date that a shareholder completely terminates his interest in the S corporation will be allocated to the deemed taxable year ending on the date of the shareholder's disposition of his stock rather than to the deemed taxable year following the date of such disposition.

3. In the event that the termination of a shareholder's entire interest in an S corporation also constitutes a "qualifying disposition" within the meaning of Reg. § 1.1368-1(g)(2) (as discussed below), the regulations provide that the election under Reg. § 1.1368-1(g)(2) cannot be made by the S corporation. In other words, the section 1377(a)(2) allocation rules take precedence over the allocation rules set forth in Reg. § 1.1368-1(g)(2) relating to qualifying dispositions.

4. Additionally, an S corporation may not make a terminating election under section 1377(a)(2) if the termination of the shareholder's interest occurs in a transaction which also results in a termination of the corporation's S election under section 1362(d). Rather, the rules of section 1362(e)(2) and (3) (see below) take precedence over the allocation rules of section 1377 and will

determine the allocation of S corporation items where a corporation's S election has been terminated. Note that the allocation rules of sections 1362(e)(3) and 1377(a)(2) differ in one important respect. An election under section 1362(e)(3) closes the books on the day before the termination of S status, whereas a terminating election under section 1377(a)(2) closes the books on the day of the termination of the shareholder's entire interest in the S corporation.

5. A terminating election under section 1377(a)(2) can be made only if a shareholder's entire interest as a shareholder in the S corporation is terminated. A shareholder's entire interest in an S corporation is considered terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases. The following are examples of events resulting in termination of a shareholder's entire interest in an S corporation:

   (A) A sale, exchange, or other disposition of all of the stock held by the shareholder;

   (B) A gift under section 102(a) of all of the shareholder's stock;

   (C) A spousal transfer under section 1041(a) of all of the shareholder's stock;

   (D) A redemption under section 317(b) of all of the shareholder's stock, regardless of whether the tax treatment of the redemption under section 302 is as a sale or exchange or as a dividend; and

   (E) The death of a shareholder.

   (F) A shareholder's entire interest in an S corporation will not be considered as terminated, however, if the shareholder retains ownership of any stock that would result in the shareholder being treated as a shareholder of the corporation under section 1362(a)(2).

   (G) In determining whether a shareholder's entire interest in an S corporation has been terminated, any options held by the shareholder (other than options that are treated as stock under Reg. § 1.1361-1(1)(4)(iii)), and any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity, will be disregarded. As such, a section 1377(a)(2) terminating election can be made when a shareholder sells all of his stock even though the shareholder remains an employee, officer and/or director of the S corporation.

6. The terminating election under section 1377(a)(2) is made by attaching a statement to the S corporation's *timely* filed original or *amended* return for the taxable year during which the shareholder's entire interest is terminated. A terminating election may be made on an amended return as well as on an original return, but a terminating election only can be made on a *timely* filed return, and not on a late return. Additionally, the regulations set forth the information that must be included in the election statement and provide that a single election statement may be filed by the S corporation for *all* terminating elections with respect to the taxable year.

7. All "affected shareholders" must consent to the terminating election.[67]

8. The shareholders required to consent to the terminating election are the shareholders described under section 1362(a)(2) that must consent to a corporation's S election. For example, if stock of an S corporation is owned by a husband and wife as community property, both husband and wife must consent to the terminating election under section 1377(a)(2). If shares of stock of an S corporation are owned by a minor, the consent to the terminating election must be made by the minor (or by the legal representative of the minor); if shares of stock of an S corporation are owned by an estate, the consent of the estate must be made by an executor or administrator of the estate; and if a trust described under section 1361(c)(2)(A) owns shares of stock of an S corporation, the person treated as the shareholder under section 1361(b)(1) must consent to the terminating election.

9. In the event a terminating election is made with respect to a shareholder who terminates his entire interest in an S corporation, that shareholder will *not*, however, be required to consent to a terminating election made with respect to the subsequent termination of another shareholder's entire interest in the S corporation during the same taxable year.

iii. If a sale of S corporation stock results in the termination of the corporation's S status, the taxable year of the termination is considered an "S termination year" as defined in section 1362(e)(4) and Reg. § 1.1362-3(a). The S termination year is divided into two short taxable years, with Subchapter S governing the first short year (which ends on the day before

---

67 *See* Footnote 65 supra and discussion in the related text.

the effective date of termination and is known as the "S short year") and with Subchapter C governing the balance of the year (the "C short year"). While the corporation generally allocates its items of income, loss, deduction and credit between the two short years based on the number of days in each year, section 1362(e)(3) allows the corporation to elect to close its books on the day before the termination date, provided that all persons who own stock during the S short year and on the first day of the C short year consent to such election.[68] Also note that under section 1362(e)(6)(D), the books will close automatically if there is a sale or exchange of 50% or more of an S corporation's stock in an S termination year, and will also close with respect to any items resulting from the application of section 338.

iv. If a shareholder disposes of 20% or more of the corporation's stock during a 30-day period, the corporation may also elect to close the books hypothetically as of the date of disposition, for purposes of allocating items of income and loss.[69] Moreover, the regulations provide that a redemption treated as an exchange under section 302(a) or section 303(a) of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions over a 30-day period during the S year will constitute a "qualifying disposition" for which the hypothetical closing of the books election may be made.

v. For dispositions of stock in an S corporation, Temporary Regulation § 1.469-2T(e)(3) requires that the resulting gain or loss be allocated among the various activities of the S corporation as if the entity had sold all of its interests (assets) in such activities, including activities conducted by ownership of a pass-through entity such as a partnership, as of a prescribed valuation date, for purposes of applying the passive activity loss limitation rules.

C. *Single Class Of Stock Requirement For S Corporations*

1. *Outstanding Shares of Stock.*

Under section 1361(b)(1)(D) and Reg. § 1.1361-1(l)(1), a corporation that has more than one class of stock will not qualify as a small business corporation, and as such, cannot be an S corporation. A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

(a) *Differences in Voting Rights.*

Reg. § 1.1361-1(l)(1) provides that differences in voting rights among shares of stock of the corporation will be disregarded in determining whether a corporation has more than one class of stock. Consequently, an S corporation may have voting and nonvoting common stock, a class

---

68 Section 1362(e)(3)(B) and Reg. §1.1362-3(b)(1).

69 Reg. § 1.1368-1(g)(2).

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 to the board of directors, as long as such shares confer identical rights to distribution and liquidation proceeds.

(b) *Non-conforming Distributions.*

The original proposed second class of stock regulations provided that even where all outstanding shares of stock conferred identical rights to distribution and liquidation proceeds, the corporation still would be treated as having more than one class of stock if the corporation made "non-conforming distributions." Non-confirming distributions were defined as distributions which differed with respect to timing or amount as to each outstanding share of stock, with certain limited exceptions. Thus, under the original proposed regulations, excessive or inadequate compensation from an S corporation to a shareholder, shareholder loans, fringe benefits to shareholders, and other constructive distributions such as excessive rental payments between a shareholder and an S corporation could cause the inadvertent termination of an S corporation's election under the non-conforming distribution rule. Under the final second class of stock regulations, however, non-conforming distributions will not cause a corporation to be treated as having more than one class of stock but such distributions (including actual, constructive or deemed distributions) that differ in timing or amount will be given the appropriate tax effect in accordance with the facts and circumstances. Thus, the Service has the power to recharacterize such distributions.[70]

(c) *Stock Taken into Account.*

Under Reg. § 1.1361-1(1)(3), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account, except for: (i) restricted stock within the meaning of Reg. § 1.1361-1(b)(3) with respect to which no section 83(b) election has been made; (ii) deferred compensation plans within the meaning of Reg. § 1.1361-1(b)(4); and (iii) straight debt under Reg. § 1.1361-1(b)(5).

(d) *Governing Provisions.*

Reg. § 1.1361-1(1)(2) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based upon the corporate charter, articles of incorporation, bylaws, applicable state law, and "binding agreements relating to distribution and liquidation proceeds" (the "Governing Provisions"). Thus, with respect to an S corporation's outstanding shares of stock, only governing provisions can cause the corporation to be treated as having a second class of stock.

(e) *Routine Commercial Contractual Arrangements.*

Reg. § 1.1361-1(1)(2) provides that routine commercial contractual arrangements, such as leases, employment agreements and loan agreements, will not be considered binding agreements relating to distribution and liquidation proceeds, and consequently will not be

---

70 Reg. § 1.1361-1(1)(2)(i).

considered Governing Provisions, *unless such agreements are entered into to circumvent the one class of stock requirement.*

(f) *State Law Requirements for Payment and Withholding of Income Tax.*

Reg. § 1.1361-1(l)(2)(ii) provides that state laws requiring a corporation to pay or withhold state income taxes on behalf of some or all of its shareholders will be disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds if, when the constructive distributions resulting from the payment of such taxes by the corporation are taken into account, the outstanding shares otherwise confer identical rights to distribution and liquidation proceeds. Consequently, a difference in timing between constructive distributions attributable to withholding and payment of taxes with respect to some of an S corporation's shareholders and actual distributions to its shareholders will not cause the corporation to be treated as having more than one class of stock.

(g) *Distributions that Take Into Account Varying Interests.*

Reg. § 1.1361-1(l)(2)(iv) provides that an agreement will not be treated as affecting the shareholders' rights to liquidation and distribution proceeds conferred by an S corporation's stock if the agreement merely provides that, as a result of a change in stock ownership, distributions in one taxable year will be made on the basis of the shareholders' varying interests in the S corporation's income during the immediately preceding taxable year. If, however, such distributions are not made within a "reasonable time" after the close of the taxable year in which the varying interests occur, such distributions may be re-characterized depending upon the facts and circumstances, but still will not result in the corporation being treated as having a second class of stock.

(h) *Buy-Sell, Redemption and Other Stock Restriction Agreements.*

Reg. § 1.1361-1(l)(2)(iii) sets forth rules regarding when buy-sell, redemption and other stock restriction agreements will be disregarded in making the determination as to whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds.

(1) Agreements Triggered by Death, Divorce, Disability or Termination of Employment. A bona fide agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment will be disregarded in determining whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds.[71]

(2) Non-Vested Stock. If stock that is substantially non-vested is treated as outstanding, the forfeiture provisions that cause the stock to be substantially non-vested will be disregarded.

(3) Buy-Sell Agreements, Stock Restriction Agreements and Redemption Agreements. Buy-sell agreements among shareholders,

---

71 Reg. § 1.1361-1(l)(2)(iii)(B).

agreements restricting the transferability of stock, and redemption agreements will be disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless:

i. A principal purpose of the agreement is to circumvent the one class of stock requirement; and

ii. 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.

(4) Determination of Value. Reg. § 1.1361-1(1)(2)(iii) provides that a price established at book value or at a price between fair market value and book value will not be considered to establish a price significantly in excess of or below the fair market value of the stock.

i. A determination of book value will be respected if the book value is determined in accordance with GAAP; or the book value is used for any substantial non-tax purpose.

ii. Additionally, the regulations provide that a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence.

(i) Special Rule for Section 338(h)(10) Elections. Reg. § 1.1361-1(1)(2)(v) provides that if the shareholders of an S corporation sell their stock in a transaction for which an election under section 338(h)(10) is made, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's-length negotiations with the purchaser. This amendment is important because the amount a shareholder is paid per share of stock (and the timing of the payment) often will vary among the shareholders (for example, due to control premiums and minority discounts); this could create a second class of stock concern if the shareholders were viewed as receiving different amounts in the fictional liquidation of the S corporation resulting from the section 338(h)(10) election.[72]

IV. Comparison of Tax Treatment of Corporations and Limited Liability Companies (LLCs)

The following discussion of the tax treatment of C corporations and S corporations and their owners to the tax treatment of LLCs and their members assumes that the LLC will be

72 *See* also PLRs 9821006 and 199918050.

classified as a partnership for federal income tax purposes. It is assumed that partnerships and LLCs will be taxed in substantially the same manner under Subchapter K of the Code.

A. *Comparison of LLC and C Corporation*

1. *Double Taxation*

The C corporation does not provide pass-through taxation for its shareholders. Instead, the corporation pays an entity level tax on its own taxable income. In addition, distributions to shareholders are also subject to tax, either as dividends or as payments in exchange for stock (capital gain or loss under section 302). This double taxation of corporate income — taxation at both the corporate and shareholder levels — can be a significant disadvantage in comparison to the S corporation, LLC or partnership. Although taxation at the shareholder level can be avoided by not making any distributions, for a variety of reasons shareholders may want to receive cash distributions. Thus, the "day of reckoning" will eventually come, unless the shareholder dies and receives a step-up in the tax basis of his stock.

The Tax Reform Act of 1986 (TRA '86) eliminated the ability of taxpayers to avoid double taxation through distributions of appreciated property. Such distributions are taxable to the C corporation under section 311(b) or section 336(a) and are also taxable to the recipient shareholders.

The LLC has an advantage over the C corporation in that the LLC will not generally be required to recognize income upon a distribution of appreciated property.[73] Section 731(c) subjects distributions of marketable securities by a partnership to treatment as a taxable event based upon the fair market value of the securities on the date of distribution. Under former law, a partner would have taken a basis in the securities equal to the lesser of the partnership's adjusted basis in the securities or the partner's adjusted basis in the partnership, and any gain would have been deferred until the partner transferred the securities in a taxable transaction. Under section 731(c), the general rule is that a partner must recognize the gain on the securities when they are distributed.

(a) Exception - Distribution to Partner. The distribution of marketable securities will not be taxed under section 731(c) if the distribution is to the partner who originally contributed the marketable securities to the partnership.

(b) Exception - Investment Partnership to Partner. The distribution of marketable securities will not be taxed under section 731(c) if it is made by an investment partnership to an eligible partner. An investment partnership is a partnership that (a) has never been engaged in a trade or business and (b) substantially all of whose assets consist of specified investment-type assets. Investment-type assets are defined by section 731(c)(3)(C)(i) to include most commonly traded investments and money but not real estate or interests in other partnerships, except another investment partnership. An eligible partner is a partner who did not

73 Section 731(b).

contribute to the partnership any property other than investment-type assets permitted to be held by an investment partnership prior to the distribution. A partnership is treated as holding a proportionate share of the assets of any lower-tier partnership and as being engaged in any trade or business conducted by a lower-tier partnership.

2. *Pass-Through of Losses*

Losses experienced by a C corporation can only be used to offset the income of the corporation, and, subject to limitations, carried back or forward to offset income in other taxable years. However, by being taxed as a partnership, an LLC that has losses will pass those losses through to its members. The members may then be able to use those losses to offset taxable income from other sources. This tax treatment may be very beneficial to owners of a business that is expected to generate net losses for some period of time. The basis, at-risk or passive loss rules may restrict a member's ability to use such losses to offset other income.

3. *Contribution of Property*

As discussed above, a shareholder will not recognize gain or loss upon the contribution of property to a corporation solely in exchange for stock if the shareholder or group of shareholders making such contribution has "control" of the corporation immediately after the exchange.[74] "Control" is defined under section 368(c) as ownership of stock constituting 80% or more of the voting power of all classes of stock entitled to vote and 80% or more of the total number of shares of all other classes of stock.

No such control requirement exists for contributions to LLCs or partnerships. Under section 721(a), a partner does not recognize any gain or loss upon the contribution of property to a partnership in exchange for a partnership interest (although an exception exists under section 721(b), like section 351(e)(1) for corporations, for contributions to an investment company, pursuant to which the contributor will be required to recognize gains but will not be permitted to recognize losses). Thus, if taxpayers wish to make contributions of appreciated property to an entity in which they do not have at least 80% control, the LLC will produce a more favorable tax treatment with respect to such contributions than will the C corporation.

If properties contributed by a shareholder to a corporation have liabilities in excess of basis and the liabilities are assumed by the corporation, section 357(c) treats that excess as taxable gain. A similar problem may sometimes be avoided for contributions to an LLC or partnership because section 752 allows a partner to include in the basis of his partnership interest his proportionate share of partnership liabilities.

4. *Accumulated Earnings Tax*

The accumulated earnings tax imposed by section 531 on certain corporations is not applicable to LLCs and partnerships.

---

[74] Section 351(a).

5. *Reasonable Compensation*

The issue of whether a corporation's compensation to an employee-owner is unreasonable, and therefore recharacterized by the IRS as a dividend rather than deductible compensation, has no counterpart applicable to LLCs and partnerships.

6. *Cash vs. Accrual Method of Accounting*

Generally, a C corporation must use the accrual method of accounting unless its gross receipts are less than $5,000,000.[75] An LLC or partnership that does not have a C corporation as a member or partner does not have to use the accrual method of accounting unless it is treated as a "tax shelter."

A "tax shelter" is defined under section 461(i)(3) and includes within its definition a "syndicate." A "syndicate" is defined in section 1256(e)(3)(B) as "any partnership . . . if more than 35% of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)). A "limited entrepreneur" is defined by section 464(e)(2) as a person who "has an interest in an enterprise other than as a limited partner, and . . . does not actively participate in the management of such enterprise." Therefore, an LLC will be treated as a syndicate and must use the accrual method of accounting if more than 35% of the losses of the LLC are allocated to members who do not actively participate in the management of the LLC.

7. *State Income and Franchise Taxes*

Many states will treat an LLC as a partnership for state income tax purposes if the LLC is classified as a partnership for federal income tax purposes. However, the tax treatments in a few states may differ. Also, the LLC may be subject to other types of state taxes that are applicable to all business organizations operating within the taxing state. An LLC that is treated as a partnership for federal income tax purposes may be subject to the state corporate franchise taxes in some states. For example, California imposes franchise taxes (and LLC fees based on gross receipts) on LLCs transacting business in the state.

8. *Disadvantages*

The LLC has a few disadvantages when compared to the C corporation:

(a) An LLC taxed as a partnership cannot take advantage of the lower tax rates imposed on the first $75,000 of taxable income of a C corporation (15% of taxable income up to $50,000 and 25% of taxable income between $50,000 and $75,000). JGA-2003 provides that the highest individual and corporate rates are identical at 35% for years 2003 through 2010 (except for the 39% rate on the "bubble" of income from $100,000 to $335,000 and the 38% rate on income from $15,000,000 to $18,333,333).

(b) The C corporation has much more flexibility in choosing its taxable year.

75 Section 448.

(c) Certain fringe benefits for business owners are deductible by C corporations but not by S corporations, LLCs or partnerships.

B. *Comparison of LLC and S Corporation*

S corporations are similar to LLCs in that both offer limited liability protection for their owners and a pass-through form of taxation. The pass-through form of taxation for S corporations is very different from the pass-through form of taxation for LLCs and partnerships. However, the S corporation provisions of the '96 Act and subsequent legislation broaden the eligibility rules for S corporations and enhance the availability and desirability of the S corporation in comparison with the LLC.

1. *Restrictions as to Shareholders*

An S corporation may have only 100 shareholders. The members of a family through six generations from a common ancestor are treated as one shareholder. Only individuals (other than nonresident aliens), estates, certain trusts, and tax-exempt organizations and qualified retirement plans are permitted as S corporation shareholders.[76] LLCs have no such restrictions and thus provide much greater flexibility in their ownership structure.

2. *Relaxed Restrictions on Affiliations; Use of QSUBs versus Single Member LLCs*

Prior to the '96 Act, section 1361(b)(2)(A) prohibited an S corporation from being a member of an affiliated group as determined under section 1504. An S corporation many now own any interest in subsidiary corporations taxable as separate entities and may elect to treat a wholly-owned subsidiary as a qualified Subchapter S subsidiary or "QSub", disregarded as an entity separate from its owner for federal income tax purposes. An LLC may hold stock in a corporation, may have a corporate member hold any percentage of its membership interests, and may be a part of other multi-tier arrangements without affecting the LLC's tax classification as a partnership.

Despite the flexibility allowed for S corporation wholly-owned subsidiaries electing to be QSubs, it appears that a single-member LLC provides all of the advantages and eliminates certain of the disadvantages that might apply to a QSub. For example, the transfer of an interest to an additional member or shareholder (or the treatment of third-party QSub debt as equity) would cause a QSub to be treated as a C corporation. On the other hand, the transfer of an interest in a single-member LLC to a second member would cause the entity to be treated as a partnership. Moreover, in the Blue Book to the 1996 Legislation, the Joint Committee indicated that in certain circumstances it may be appropriate for a QSub to be treated as a separate corporation for certain federal income tax purposes (and § 1601(c)(3) of TRA '97 authorized the IRS to issue regulations in this regard).

A statutory merger of two corporations pursuant to state law is treated as a tax free "A" reorganization under section 368(a)(1)(A). Regulations proposed in 2000 provided that a domestic merger of a corporation into a disregarded entity (i.e., a QSub or a single member LLC) owned by a corporation could not qualify under section 368(a)(1)(A), on the theory that there

[76] Section 1361(b)(1).

had been no statutory merger into a corporation, as required by section 368(a)(1)(A). Reg. § 301.7701-2(a) treats the disregarded entity as part of the owner corporation for all tax purposes.

Reg. § 1.368-2, proposed in November, 2001 and finalized in January 2003, reversed the position taken in the 2000 proposed regulations and allows a merger involving a disregarded entity to be qualified under section 368(a)(1)(A). The final regulations define a merger as a transaction affected pursuant to statute whereby, at the effective time, all of the assets and liabilities of all members of the transferor "combining unit" (each a "transferor unit") become the assets and liabilities of one or more members of one other combining unit (the "transferee unit"); and the combining entity of each transferor unit ceases its separate legal existence for all purposes. A combining unit is a combining entity and all disregarded entities owned by it. A combining entity is a business entity that is a corporation and is not disregarded. Because business entity is defined in Reg. § 301.7701-2(a) as a state law entity, this means that a state law entity that is treated as a corporation for tax purposes must be at the top of the combining unit. These definitions will permit simultaneous mergers of a QSub and another corporation or a merger of a corporation and its single-member LLCs with another corporation and its single-member LLCs. The final regulations clearly do not permit a divisive transaction whereby an LLC is merged into a corporation, leaving behind the LLC's parent.

3. *One Class of Stock*

As discussed above, an S corporation may not have more than one class of stock.[77] As a result, an S corporation has little flexibility in structuring its equity and debt interests because of the second class of stock rule. However, an LLC may have several classes of equity and debt, and thus provides much greater flexibility to its members in the structuring of their financial interests.

4. *Special Allocations*

An S corporation may not make special allocations of income and losses without risking violation of the second class of stock prohibition. Also, section 1377(a) requires that an S corporation shareholder's share of income or loss be determined on a per-share per-day basis. If the "substantial economic effect rules" of section 704(b) are satisfied, an LLC may have preferred returns and special allocations of income and loss to its members, thus providing much more flexibility in allocating income and deductions to the owners when compared to the S corporation.

5. *Formation*

The differences in the tax consequences of contributions of property to a C or S corporation under section 351 as compared to contributions to an LLC or a partnership under section 721 are discussed above in the C corporation comparison. It should also be noted that in certain circumstances a member or partner can contribute services to an LLC or partnership in exchange for a profits interest without triggering the current recognition of income, but the same is not true for the C or S corporation. In addition, if the "disguised sale" rules are avoided, the

[77] Section 1361(b)(1)(D), discussed further in Section III.C. of this outline.

contributing member or partner can receive cash back from the LLC or partnership in an amount less than his basis in his membership or partnership interest at the time of his capital contribution without the recognition of income.

6. *Outside Basis in Ownership Interest*

An S corporation shareholder can deduct his proportionate share of losses from the corporation only to the extent that such losses do not exceed the shareholder's basis in his stock (amount paid to purchase the stock and basis of property contributed to the corporation) and the basis in any direct loans by the shareholder to the corporation.[78] Similarly, an LLC member or partner can deduct his share of losses from the LLC or partnership to the extent of his basis in his membership or partnership interest. However, that basis is computed differently under section 752, which allows a member or partner to include in his basis his proportionate share of the liabilities of the LLC or partnership. For purposes of determining basis under section 752, recourse liabilities are allocated only to the members or partners who have the economic risk of loss with respect to such liabilities, while nonrecourse liabilities are allocated to all members or partners.

This additional basis available to members or partners as a result of third party loans to the LLC or partnership increases the ability of members or partners to utilize losses passed through from the LLC or partnership to offset income from other sources. However, the at-risk rules (section 465) and passive loss rules (section 469) may further restrict the ability of members and partners to use those losses.

7. *Inside Basis*

When an S corporation shareholder dies, his stock receives a step-up in basis to fair market value at the date of death, but the inside basis of the S corporation's assets is not changed. Therefore, if the S corporation sells its assets for a gain subsequent to the date of death of a shareholder, the estate or successor shareholder must include in taxable income his proportionate share of the gain. The shareholder will receive an increase in the basis of his stock for the amount of the gain passed through to the shareholder and then presumably will have an offsetting loss on the subsequent liquidation of the corporation or sale of his stock. However, such liquidation or sale may not occur until years later and thus could present a timing problem. Furthermore, some of the gain passed through to the shareholder from the sale of the corporation's assets may be ordinary income (e.g., depreciation recapture), but the loss on the subsequent corporate liquidation or stock sale will be a capital loss. In addition, an individual may deduct only $3,000 per year on account of capital losses in excess of capital gains.

An LLC or partnership can avoid this problem with a section 754 election. If such an election (which is irrevocable once made) is made or is already in place for an LLC or partnership, upon the death of a member or a partner or upon the sale of an interest in the LLC or partnership, the LLC's or partnership's basis in its assets will be stepped-up to reflect either (i) the excess of the fair market value of the interest at death over the basis in the interest immediately prior to death, or (ii) gain on the sale of the interest, as the case may be.[79] The step-

[78] Section 1366(d)(1).
[79] Section 743.

up in inside basis is made only with respect to the transferee member or partner. Section 734 allows a similar adjustment in the case of a liquidation of a member's or partner's interest.

S corporations are not entitled to such a basis adjustment. Therefore, the section 754 election can provide a significant tax advantage for the LLC or partnership over the S corporation.

8. *Distributions*

As is the case with C corporations, an S corporation must recognize gain upon the distribution of appreciated property. On the other hand, an LLC or partnership does not recognize gain as a result of property distributions under section 731(b), except with respect to the distribution of marketable securities in accordance with section 731(c).

Distributions to a shareholder of an S corporation having no accumulated earnings and profits are tax free to the extent of the shareholder's basis in his stock and are treated as gain from the sale or exchange of property to the extent of any excess.[80] Distributions to shareholders of S corporations having accumulated earnings and profits are taxed in the same manner as under section 1368(b) to the extent of the accumulated adjustments account ("AAA"), any remaining distribution is taxed as a dividend to the extent of accumulated earnings and profits, and any remaining distribution is taxed in the manner provided in section 1368(b).[81]

Generally, an LLC member or a partner does not recognize any gain upon the distribution of money to him from the LLC or partnership except to the extent that the money received exceeds his basis in his membership or partnership interest, and he does not recognize a loss upon a nonliquidating distribution.[82] An exception exists under Code 704(c)(1)(B) with respect to a distribution of property with a value different from its basis at the time the property is contributed to the LLC or partnership, which property is distributed to another member or partner within seven (7) years of contribution. In that case, the contributing member or partner must recognize gain as if such property were sold for its fair market value at the time of distribution.

9. *Status*

A corporation must make a timely election to be treated as an S corporation and must make sure that both it and its shareholders continue to meet all applicable eligibility requirements for S corporations. An LLC does not have to make an election to be treated as a partnership, because it will generally assume this classification under the default rules provided in the final "check-the-box" regulations.[83] Unlike an LLC, an S corporation is at risk of losing its pass-through tax status due to the numerous eligibility requirements.

Furthermore, an S corporation may be exposed to a threat by a disgruntled shareholder to terminate the S corporation status, even if the shareholder is accountable for such action under a

---

80 Section 1368(b).
81 Section 1368(c).
82 Section 731(a).
83 Reg. § 301.7701-1 through 301.7701-3.

shareholder agreement that prohibits a shareholder from revoking the S corporation election. In contrast, the tax classification of an LLC is not subject to this type of risk.

10. *Entity Level Taxes*

Sections 1374 and 1375 provide for taxes at the S corporation level on built-in gains and passive investment income of S corporations that used to be C corporations. The LLC has no similar entity level tax.

11. *Retirement Payments*

Payments made to a retiring member or partner that qualify under section 736(a) will be treated as either a distributive share of LLC or partnership income or as a guaranteed payment, effectively reducing the amount of income that is reportable by the other members or partners. No comparable provision exists for S corporations.

12. *Social Security and Self-Employment Tax Considerations*

The ability of a shareholder/employee in an S corporation to obtain distributions from an S corporation free of exposure to self-employment tax (assuming a reasonable salary is paid to the individual for services rendered) can be a key issue for extremely profitable businesses that are very closely held or owned by a single member.

13. *Tax-Free Acquisitions and Reorganizations*

An S corporation, unlike an LLC, may engage in a tax-free reorganization pursuant to section 368. If the parties anticipate a tax-free exchange of stock with an acquiring corporation, an S corporation, unlike an LLC, will allow for the reorganization to be accomplished on a tax-free basis. Even if the entity is expected to be sold in a taxable transaction, S corporation stock can be sold at capital gains rates without any "hot asset" concerns as exists with respect to the sale of LLC interests subject to section 751 recharacterization.

14. *Divisions*

A corporate spin-off, split-off, or other division must satisfy the requirements of section 355 (including having a business purpose) to avoid the recognition of gain. A partnership or LLC division can be structured as nontaxable under Section 708(b)(2)(B) provided the seven year waiting period for distributions of property to a non-contributing partner does not trigger gain.

15. *Miscellaneous Considerations*

S corporations may also continue to be advantageous when compared to LLC's due to (i) their relative simplicity as compared with a comprehensive LLC operating agreement, (ii) the comparative certainty of limited liability protection to the shareholders of an S corporation compared to the untested protection of LLCs, and (iii) the ability of any S corporation shareholder to be treated as an "employee" of the S corporation. When small equity interests are transferred to employees of an S corporation, a less than 2% S corporation shareholder will not face any changes in his or her benefits or wage withholding. On the other hand, even a de minimis member of an LLC will no longer be an "employee," and such an individual will face the prospect of making estimated tax payments in lieu of wage withholding and a loss of certain employee fringe benefits under the same rules that apply to general partners. Stock option and restricted stock plans may be adopted by S corporations and allow for potential "incentive stock option" and capital gain treatment which might not be available for similar plans developed for LLCs.

16. *Disadvantages of the LLC in Comparison to the S Corporation*

(a) Lower Tax Cost of Conversion. The conversion of an existing C corporation to an S corporation involves less tax cost and is less of an administrative burden than is a conversion of a C corporation to an LLC. The conversion of a C corporation to an S corporation generally is not taxable, although the C corporation is required by section 1363(d) to recapture LIFO benefits upon conversion, and the S corporation will be subject to the taxes on built-in gains and passive investment income under sections 1374 and 1375, respectively. The conversion may be accomplished simply by filing the S election with the IRS. On the other hand, a conversion of a C corporation to an LLC cannot be done tax free and involves a liquidation of the corporate entity by merging with an LLC or the creation of a new entity.

(b) Termination. An LLC or partnership will be deemed to be terminated for tax purposes under section 708 if 50% or more of the interests in capital and profits of the entity are sold or exchanged within a 12-month period. No such similar rule exists for S corporations.

(c) Sale of Substantial Interest. Under section 751, if a member or partner of an LLC or partnership sells or exchanges all or part of his membership or partnership interest or receives a disproportionate distribution, the member or partner must recognize ordinary income to the extent that his interest in the LLC's or partnership's unrealized receivables and substantially appreciated inventory is reduced.

(d) Passive Loss. The passive loss rules (section 469) are more restrictive in their application to limited partners than they are to S corporation shareholders. Whether a member of an LLC will be treated as a limited partner for purposes of these rules is not clear. However, it is arguable that any member of a member-managed LLC or a member who is a manager of a manager-managed LLC may be treated as a general partner for purposes of the passive loss rules.

(e) Membership. The LLC must have at least two members to be taxed as a partnership. A single-member LLC will be disregarded as an entity separate from its owner and will be treated as a sole proprietorship, branch or division for federal tax purposes. An S corporation is not restricted from having only one shareholder.