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## Choice of Business Entity

C. Wells Hall III

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# CHOICE OF BUSINESS ENTITY

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## TABLE OF CONTENTS

	PAGE
<b>I. INTRODUCTION.....</b>	<b>1</b>
<b>II. ADVANTAGES OF OPERATING CLOSELY HELD BUSINESS AS AN S CORPORATION OR OTHER PASS-THROUGH ENTITY VERSUS A C CORPORATION .....</b>	<b>1</b>
<b>A. No Double Tax on Earnings or Sale of Assets .....</b>	<b>1</b>
<b>B. No Alternative Minimum Tax .....</b>	<b>4</b>
<b>C. Deductibility of Interest Paid on Debt to Purchase Interests .....</b>	<b>5</b>
<b>D. Social Security Taxes.....</b>	<b>5</b>
<b>E. Avoidance of 3.8% Tax on Net Investment Income for Material Participation Owners.....</b>	<b>7</b>
<b>F. Avoidance of the Accumulated Earnings Tax .....</b>	<b>8</b>
<b>G. Avoidance of the Personal Holding Company Tax .....</b>	<b>9</b>
<b>H. Absence of Limitations on Use of Cash Method of Accounting .....</b>	<b>9</b>
<b>I. Ability to Use Pass-Through Losses to Offset Other Income.....</b>	<b>9</b>
<b>J. Avoidance of State Income Taxes .....</b>	<b>10</b>
<b>III. DISADVANTAGES OF OPERATING A CORPORATION AS AN S CORPORATION (OR OTHER PASS-THROUGH ENTITY) VERSUS A C CORPORATION .....</b>	<b>10</b>
<b>A. Multiple Classes of Stock .....</b>	<b>10</b>
<b>B. Losses on Small Business Stock.....</b>	<b>10</b>
<b>C. Exclusion of Gain on Qualified Small Business Stock.....</b>	<b>11</b>
<b>D. Shareholder Level Tax on Undistributed Income .....</b>	<b>11</b>
<b>E. Benefit of Lower Corporate Tax Rates.....</b>	<b>11</b>
<b>F. Limitations on Filing Consolidated Returns .....</b>	<b>11</b>
<b>G. Loss of Tax-Free Fringe Benefits .....</b>	<b>12</b>
<b>H. S Corporation Eligibility Restrictions.....</b>	<b>13</b>
<b>I. Limitations on Taxable Year .....</b>	<b>13</b>
<b>J. Tax Costs of Converting From C to S Status on Liquidation .....</b>	<b>14</b>
<b>IV. DISADVANTAGES OF OPERATING AS AN LLC VERSUS AN S CORPORATION .....</b>	<b>14</b>
<b>A. Employment Tax.....</b>	<b>14</b>
<b>B. Partners Cannot be Employees .....</b>	<b>23</b>
<b>C. Reorganization Provisions .....</b>	<b>24</b>
1. Tax-Free Reorganizations are Limited to Corporations .....	24
2. Partnerships Not Eligible for Tax-Free Reorganization Treatment.....	24
<b>D. Cancellation of Debt/Insolvency.....</b>	<b>25</b>
<b>V. CONVERSION OF TYPE OF ENTITY AND DISREGARDED ENTITIES .....</b>	<b>25</b>
<b>A. Overview .....</b>	<b>25</b>
<b>B. Change of a Sole Proprietorship or Disregarded Entity into an Association Taxable as a Corporation .....</b>	<b>26</b>

1.	In General.....	26
2.	General Incorporation Rules .....	26
3.	Tax Consequences to the Shareholder .....	29
4.	Tax Consequences to the Corporation .....	29
5.	Other Considerations .....	30
6.	From QSub to Association Taxable as a Corporation – Termination of QSub Election.....	30
7.	From QRS to Association Taxable as a Corporation; TRS Election .....	32
C.	Changing a Corporation into a Sole Proprietorship or a Disregarded Entity (Single- Member Limited Liability Company).....	33
1.	In General.....	33
2.	Tax Consequences to the Corporation .....	33
3.	Tax Consequences to the Shareholder .....	34
4.	From Corporation to QSub Status – the QSub Election .....	35
D.	Conversions of a Disregarded Entity into a Partnership and a Partnership into a Disregarded Entity .....	42
1.	In General.....	42
2.	Conversion of a Disregarded Entity into a Partnership; Increase From One Member to Two (or More) Members .....	43
3.	Conversion of a Partnership Into a Disregarded Entity; Purchase of All Of the Interests in an LLC Taxable as a Partnership by One Buyer .....	43
4.	AICPA Proposes that Rev. Rul. 99-6 be Revoked or Clarified .....	44
VI.	<b>USE OF DISREGARDED ENTITIES IN TAX PLANNING .....</b>	<b>44</b>
A.	Disregarded Entities in Corporate Reorganizations.....	44
1.	Proposed and Final Regulations on Mergers Involving Disregarded Entities .....	44
2.	Reorganizations Involving QSubs .....	46
B.	Like-Kind Exchanges Using Disregarded Entities .....	48
VII.	<b>ENTITY OF CHOICE AND ENTITY STRUCTURES FOR SPECIFIC APPLICATIONS .....</b>	<b>51</b>
A.	The Operating Business .....	51
B.	The Professional Practice.....	51
C.	Structuring Private Equity Fund Investments .....	51
1.	General.....	51
2.	Structuring Private Equity Investments in an Operating Company .....	52
D.	Real Estate Investments .....	58
1.	Advantages of Partnerships and Limited Liability Companies to Hold Real Property .....	58
2.	Private REIT Structures .....	59
3.	The UPREIT Structure.....	66
E.	Structuring Parent Subsidiary Arrangements.....	68
1.	Consolidated Return for Parent Subsidiary Corporations.....	68
2.	The Single Member LLC .....	68

# CHOICE OF BUSINESS ENTITY

By  
C. Wells Hall III

## I. INTRODUCTION

This outline will cover the choice of business entity analysis based upon current law, including recent developments in the reasonable compensation area, the self-employment tax area, and the recent legislation making permanent the 100% exclusion under Section 1202 of the Internal Revenue Code of 1986 (the "Code")<sup>1</sup> for certain sales of C corporation stock. Conversions of entities and disregarded entities will be discussed, along with the use of disregarded entities in tax planning and structuring parent subsidiary arrangements (LLC versus QSub, and LLC versus corporate subsidiary of C corporation).

The outline will discuss the general advantages and disadvantages applicable to each type of entity translates when applied to specific types of business, including operating businesses, professional service businesses, businesses operated by private equity funds, and entity structures for real estate investments, including private REITs and UPREITs.

## II. ADVANTAGES OF OPERATING CLOSELY HELD BUSINESS AS AN S CORPORATION OR OTHER PASS-THROUGH ENTITY VERSUS A C CORPORATION

Set forth below is an examination of both the advantages and disadvantages of operating a corporation as an S corporation (or other pass-through entity) versus a C corporation.

### A. No Double Tax on Earnings or Sale of Assets

Under Section 1363(a), an S corporation is generally treated as a pass-through entity and not as a taxable entity for federal income tax purposes, and as such, its shareholders are generally subject to only one level of tax on its earnings. Section 1374, however, imposes a tax on the built-in gains of S corporations that were formerly C corporations for a 5-year recognition period beginning on the date of the corporation's conversion to S corporation status. Additionally, under Section 1375, a corporate level tax is imposed on the excess net passive investment income of S corporations having subchapter C earnings and profits. Under Section 1366(a), subject to certain limited exceptions, all items of income, loss, deduction and credit of an S corporation pass through the corporation and are taxed directly to its shareholders in proportion to their respective ownership interests in the corporation. In turn, under Section 1367, a shareholder's basis in his or her S corporation stock is increased by such shareholder's proportionate share of the income of the S corporation and decreased by such shareholder's proportionate share of the losses of the S corporation as well as by distributions of cash and property to such shareholder to the extent such distributions are received tax-free. As a general rule, distributions of cash and/or property to an S corporation shareholder may be received tax-free by the shareholder to the extent of the

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<sup>1</sup> Unless otherwise specified, all "Section" and "§" references are to the Code and all "Regulation" and "Reg. §" references are to the Treasury regulations promulgated under the Code.

shareholder's basis in his or her S corporation stock.<sup>2</sup> To the extent that distributions exceed a shareholder's basis in his or her stock, however, the excess is generally treated as capital gain.<sup>3</sup>

The rules applicable to partnerships are similar but even more flexible and don't involve any taxes imposed at the entity level.

Because S corporations and other pass-through entities are by their nature generally subject to only one level of tax, such entities need not pay out large amounts of compensation in order to reduce their taxable income to zero as does a C corporation. Consequently, an S corporation is not subject to traditional unreasonable compensation arguments to which C corporations are susceptible. S corporations may, however, be subject to unreasonable compensation arguments in at least three situations. First, under Section 1366(e), the IRS is expressly authorized to recharacterize S corporation distributions as wages of a particular shareholder where such shareholder is a member of the family of one or more of the other shareholders and has rendered services for the corporation without receiving reasonable compensation for such services. Second, the IRS has successfully recharacterized S corporation distributions as wages subject to social security taxes where wages have been set at an unreasonably low level.<sup>4</sup> Lastly, the reduction of an S corporation's taxable income for purposes of minimizing the built-in gains tax by means of the payment of excessive compensation could prompt the IRS to use unreasonable compensation arguments in this context.

Unlike S corporations and other pass-through entities, the earnings of C corporations are subject to two levels of tax, once at the corporate level and again at the shareholder level when such earnings are distributed to the shareholders as dividends. Although the maximum tax rate on dividends is only 20%, the after-tax earnings of a C corporation distributed to the corporation's shareholders as dividends are still subject to double taxation at a higher tax rate than if the corporation were an S corporation or other pass-through entity and the earnings were subject to a single level of tax at the shareholder, partner or member level. The difference in tax rates will be even more pronounced in states that impose corporate income taxes on C corporations but not on S corporations, such as Florida.

*Recent Developments in Reasonable Compensation.* In the professional corporation context, however, the double tax on corporate earnings to which most C corporations are subject has not been viewed as an advantage of S corporations over C corporations because of the strategy employed by professional corporations of bonusing out sufficient amounts of compensation to the professional corporation's shareholder-employees to reduce the corporation's taxable income to zero. Consequently, a professional corporation using the strategy of zeroing out its taxable income will not be subject to any tax at the corporate level, but rather, its shareholders will be subject to tax on the corporation's income at the maximum marginal individual tax rate, the same as if the

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<sup>2</sup> Section 1368(b)(1).

<sup>3</sup> Section 1368(b)(2).

<sup>4</sup> See *Radtke v. U.S.*, 712 F. Supp. 143, 89-2 USTC ¶9466 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196, 90-1 USTC ¶50,113 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80, 91-1 USTC ¶50,103 (9th Cir. 1990); *C.D. Ulrich, Ltd. v. U.S.*, 692 F. Supp. 1053, 88-1 USTC ¶9318 (D. Minn. 1988); *Van Camp and Brennon v. U.S.*, 251 F.3d 862, 2001-1 USTC ¶50,446 (9th Cir. 2001); *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 TC 14 (2001); *Old Raleigh Realty Corp. v. Commissioner*, TC Summ. Op. 2002-61; and *David E. Watson P.C. v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).

corporation were an S corporation. As will be discussed immediately below, however, recent cases have subjected professional corporations to double tax on their earnings, based upon unreasonable compensation arguments.

In *Brinks Gilson & Lione, P.C. v. Commissioner*,<sup>5</sup> the Tax Court applied the independent investor test to recharacterize compensation paid by a professional corporation, a law firm, to its shareholder-employees as nondeductible dividend distributions, and held the corporation liable for accuracy-related penalties for mischaracterizing the dividends as deductible compensation. The taxpayer was an intellectual property law firm organized as a C corporation which used the cash basis of accounting. During the years in issue, the taxpayer employed about 150 attorneys, of whom about 65 were shareholders, and also employed a non-attorney staff of about 270.

Each shareholder-attorney of the taxpayer acquired his or her shares at a price equal to their book value and is required by agreement to sell his or her shares back to the taxpayer at a price determined under the same formula upon terminating his or her employment. Subject to minor exceptions related to the firm's "name partners," each shareholder-attorney's proportionate ownership of taxpayer's shares ("share-ownership percentage") equals his or her proportionate share of compensation paid by the taxpayer to its shareholder-attorneys. For the years in issue, the board of directors of the taxpayer set the yearly compensation to be paid to shareholder-attorneys and then determined the adjustments in the shareholder-attorneys' share-ownership percentages necessary to reflect changes in proportionate compensation. These adjustments in share ownership were effected by share redemptions and reissuances.

For at least 10 years prior to and including the years in issue, the taxpayer did not pay any dividends to its shareholders. In late November or early December of the year preceding the compensation year, the taxpayer's board meets to set the amount available for all shareholder-attorney compensation for that year, set compensation and share-ownership percentages. Because the board's estimate of the amount available for compensation-year payments to shareholder-attorneys is only an estimate, each shareholder-attorney receives during the course of the compensation year only a percentage of his or her expected compensation (draw), with the expectation of receiving an additional amount (year-end bonus) at the end of the year. The board intended the sum of the shareholder-attorneys' year-end bonuses to reduce the taxpayer's book income to zero. With limited exceptions for certain older, less active attorneys, shareholder-attorneys shared in the bonus pool in proportion to their draws (and, likewise, in proportion to their share-ownership percentages).

For each of the years in issue, 2007 and 2008, the taxpayer calculated the year-end bonus pool for 2007 to be \$8,986,608 and for 2008 to be \$13,736,331, which equaled its book income for the year after subtracting all expenses other than the bonuses. The taxpayer treated as employee compensation the total amounts paid to its shareholder-attorneys, including the year-end bonuses. The taxpayer used an independent payroll processing firm to prepare Forms W-2 for 2007 and 2008 to its shareholder-employees, which Forms W-2 were then forwarded to its accountant.

The taxpayer had invested capital, measured by the book value of its shareholders' equity, of approximately \$8 million at the end of 2007 and approximately \$9.3 million at the end of 2008.

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<sup>5</sup> TC Memo 2016-20.



The taxpayer's return had previously been audited for 2006, and resulted in a "no change" letter. However, when the IRS audited the taxpayer for 2007 and 2008, the year-end bonuses that the taxpayer paid to its shareholder-attorneys were disallowed as nondeductible dividend distributions. After negotiations, the parties entered into a closing agreement providing that portions of the taxpayer's compensation deductions to its shareholder-employees for the years in issue, \$1,627,000 in 2007 and \$1,859,000 in 2008, should be disallowed and recharacterized as nondeductible dividends. Consequently, the only issue remaining for decision was whether the taxpayer was liable for accuracy-related penalties on underpayments of tax relating to amounts deducted as compensation that it conceded were nondeductible dividends.

The Tax Court's conclusion that the taxpayer did not have substantial authority for its position and was subject to penalties provides valuable insight as to the Tax Court's current position on the ability to recharacterize wages paid to shareholder-employees of professional corporations as nondeductible dividend distributions based on the independent investor test.

*Sale of Assets.* The repeal of the *General Utilities* doctrine by the Tax Reform of 1986<sup>6</sup> has made the S corporation attractive for corporations which will hold appreciated property. As a general rule, the shareholders of an S corporation are subject to only one level of tax on the sale of the corporation's property or on the corporation's liquidation. C corporations and their shareholders, on the other hand, generally will be subject to a double tax on the sale of the corporation's assets or upon the corporation's liquidation.<sup>7</sup> Consequently, corporations which will be (or which are) holding real property or other substantially appreciated property, operation in S corporation form will allow such property to be subject to only a single level of tax at capital gains rates on its sale or on the liquidation of the corporation.

## **B. No Alternative Minimum Tax**

The corporate alternative minimum tax ("AMT") is a separate and independent tax that is parallel to the "regular" corporate income tax.<sup>8</sup> It is designed to reduce a corporation's ability to avoid taxes by using certain deductions and other tax benefit items. The corporate AMT does this by applying to a more comprehensive base than the regular income tax, and by limiting the extent to which net operating loss carryovers and tax credits can be used to reduce taxes.

Certain "small" corporations are exempt from the AMT. These are corporations whose average annual gross receipts for all three-year periods beginning after 1993 and ending before the current year do not exceed \$7.5 million.<sup>9</sup> For the corporation's first three-year period (or portion of a period), the limit is \$5 million instead of \$7.5 million.<sup>10</sup> This problem may be completely avoided, however, if the corporation operates in S corporation form rather than in C corporation form, since an S corporation is not subject to the alternative minimum tax.

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<sup>6</sup> Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>7</sup> Section 336 and 331.

<sup>8</sup> Section 55(a).

<sup>9</sup> Section 55(e)(1)(A).

<sup>10</sup> Section 55(e)(1)(B).

### C. Deductibility of Interest Paid on Debt to Purchase Interests

Under Notice 89-35,<sup>11</sup> debt proceeds allocated under Temp. Reg. § 1.163-8T to the purchase of stock in an S corporation, together with the associated interest expense, is allocated among the assets of the S corporation using any reasonable method. Examples of reasonable allocation methods include pro rata allocations based on the fair market value, book value or adjusted bases of the S corporation's assets, reduced by any debt of the S corporation or of the shareholders allocated to such assets. Thus, to the extent that the assets of a corporation (which is an S corporation) are assets used in the conduct of the corporation's trade or business, the interest expense on debt incurred to purchase the stock of the S corporation will be fully deductible as trade or business interest and not subject to the investment interest limitations prescribed under Section 163(d). To the extent that the assets of an S corporation constitute investment assets, however, an allocable portion of the interest expense associated with the debt incurred to purchase the S corporation stock will be subject to the Section 163(d) investment interest limitation.

In the case of the purchase of stock in a corporation which is a C corporation, there is a reasonable possibility that the interest expense associated with the debt incurred to purchase such stock will be subject to the investment interest limitations prescribed under Section 163(d). Specifically, the C corporation shareholder must show that he or she had no "substantial investment motive" in purchasing the stock of the corporation in order to avoid the investment interest limitation rules.<sup>12</sup> In other words, the C corporation shareholder must show that his or her purchase of the stock of the corporation was made to protect the shareholder-employee's status as an *employee* of the corporation rather than as a *shareholder* of the corporation. Although there is a greater likelihood in the C context than in the S context that the interest expense associated with debt incurred by a shareholder to purchase stock will be characterized as investment interest, in the professional service corporation setting, the C corporation shareholder would have a better chance of demonstrating the lack of a substantial investment motive in purchasing such stock, especially where such shareholder's stock is subject to a shareholders' agreement which subjects his or her shares to repurchase upon termination of employment at a purchase price based upon the *book value* of such shares, which is common in many professional service corporations.

### D. Social Security Taxes

As part of FICA, a tax is imposed on employees and employers up to a prescribed maximum amount of employee wages. This tax is comprised of two parts, the Old-Age, Survivor, and Disability Insurance (OASDI) portion and the Medicare Hospital Insurance (HI) portion. The HI tax rate is 1.45% on both the employer and the employee, and the OASDI tax rate is 6.2% on both the employer and the employee. The maximum wages subject to the OASDI tax rate for 2016 is \$118,500.00.

Under SECA, a tax is imposed on an individual's self-employment income. The self-employment tax is the same as the total rate for the employer's and employee's FICA tax (2.9% HI tax rate and 12.4% OASDI tax rate).

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<sup>11</sup> 1989-1 C.B. 675.

<sup>12</sup> See *Polakis v. Commissioner*, 91 TC 660 (1988); *Miller v. Commissioner*, 70 TC 448 (1978); *Houston v. Commissioner*, TC Memo. 1989-175; *Olson v. Commissioner*, TC Memo. 1989-564.

RRA '93 repealed the dollar limit on wages and self-employment income subject to the HI portion of the FICA tax as well as the self-employment tax. Thus, employers and employees will equally be subject to the 1.45% HI tax on *all* wages, and self-employed individuals will be subject to the 2.9% HI tax on *all* self-employment income.

The Health Care and Education Reconciliation Act of 2010 increased the Medicare portion of the self-employment tax by .9% (to 3.8%) on wages in excess of \$250,000 in the case of taxpayers filing a joint return and more than \$200,000 for other taxpayers.

Because the Federal Insurance Contributions Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes may be substantial, many shareholder-employees of S corporations have employed a strategy of decreasing the amount of wages that they receive from the S corporation and correspondingly increasing the amount of S corporation distributions made to them.

In order for shareholder-employees of S corporations to realize employment tax savings by withdrawing funds in the form of distributions rather than compensation, such distributions must not be recharacterized as "wages" for FICA purposes or as NESE for purposes of the SE Tax. For FICA and FUTA purposes, Section 3121(a) and 3306(b), respectively, define the term "wages" to mean all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Although it might appear at first glance that a shareholder's distributive share of income from an S corporation constitutes NESE since a general partner's distributive share of the income of any trade or business carried on by a partnership of which he is a member generally constitutes NESE subject to the SE Tax, in Rev. Rul. 59-221,<sup>13</sup> the IRS found that an S corporation's income does not constitute NESE for purposes of the SE Tax. Additionally, Section 1402(a)(2) specifically excludes from the definition of NESE dividends on shares of stock issued by a corporation.

Consequently, neither a shareholder's distributive share of income passed through from the S corporation under Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute NESE subject to the SE Tax. In Rev. Rul. 66-327,<sup>14</sup> the IRS found that the taxable income of an S corporation included in its shareholders' gross income is not income derived from a trade or business for purposes of computing the shareholders' net operating losses under Section 172(c). Similarly, in Ltr. Rul. 8716060, the IRS concluded that the income derived by a shareholder-employee from an S corporation did not constitute net earnings from self-employment for self-employment tax purposes and that such taxpayer was not eligible to adopt a qualified pension plan based on the income derived from his S corporation since such income did not constitute earned income.

Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages. Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, the tax practitioner should analyze the

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<sup>13</sup> 1959-1 C.B. 225.

<sup>14</sup> 1966-2 C.B. 357.

economic and tax consequences that such a strategy will have on the S corporation and its shareholders.

In Rev. Rul. 74-44,<sup>15</sup> two shareholders of an S corporation withdrew *no salary* from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed. This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and Federal Unemployment Tax Act (“FUTA”) purposes (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Rev. Rul. 74-44 clearly indicates that the payment of *no* compensation will be unreasonable where shareholder-employees provide substantial services to the corporation.<sup>16</sup>

In *Radtke v. United States*,<sup>17</sup> the court recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, where the shareholder made all of his withdrawals from the S corporation in the form of S corporation distributions and received *no salary* from the S corporation during the tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in *Spicer Accounting, Incorporated v. United States*,<sup>18</sup> the court recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes where the shareholder received *no salary* during the tax year.

#### **E. Avoidance of 3.8% Tax on Net Investment Income for Material Participation Owners**

The ACA imposes a 3.8% tax on the “net investment income” of taxpayers having modified adjusted gross income of over \$250,000 in the case of taxpayers filing a joint return and over \$200,000 for other taxpayers (the “NII Tax”). “Net investment income” includes gross income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business.<sup>19</sup>

Additionally, the term “net investment income” includes: (1) any other gross income derived from a trade or business if such trade or business is a “passive activity” within the meaning

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<sup>15</sup> 1974-1 C.B. 287.

<sup>16</sup> See also Rev. Rul. 71-86, 1971-1 C.B. 285 (president and sole shareholder of closely-held corporation found to be an “employee” of the corporation for employment tax purposes); Rev. Rul. 73-361, 1973-2 C.B. 331 (officer-shareholder of an S corporation who performed substantial services as an officer of the S corporation is an “employee” of the corporation for purposes of FICA, FUTA and income tax withholding); and Ltr. Rul. 7949022 (shareholder-employees of S corporation who perform substantial services for S corporation treated as “employees” for employment tax purposes).

<sup>17</sup> 895 F.2d 1196 (7th Cir. 1990).

<sup>18</sup> 918 F.2d 80 (9th Cir. 1990).

<sup>19</sup> Section 1411(c)(1)(A)(i).

of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.<sup>20</sup>

Consequently, now a partner, including a limited partner, LLC member and an S corporation shareholder, will be subject to the new 3.8% net investment income tax on his or her distributive share of the *operating income* of the partnership, LLC or S corporation, as the case may be, if the activity generating such income is passive under Section 469 with respect to such partner, LLC member or S corporation shareholder.

As discussed above, shareholder-employees of S corporations are generally not subject to Social Security taxes on their distributive share of the income of an S corporation or on dividend distributions made to them by their S corporation, provided the S corporation pays reasonable compensation to them.<sup>21</sup> Thus, there is an opportunity for significant employment tax savings by maximizing the amount of distributions and minimizing the amount of wages paid to shareholder-employees of S corporations.

Although it may be possible for an LLC member or limited partner to materially participate so that his or her distributive share of income would not be subject to the NII Tax, as will be discussed in more detail below, that would likely result in that member's or partner's distributive share of the income of the LLC or partnership being subject to the self-employment tax, including the increased 3.8% tax imposed on the self-employment income of higher income taxpayers.<sup>22</sup> Thus, S corporations appear to be the most attractive vehicle in which to operate a business to minimize both employment taxes and the NII Tax.

#### **F. Avoidance of the Accumulated Earnings Tax**

S corporations and other pass-through entities are not subject to the Accumulated Earnings Tax imposed under Section 531.

The accumulated earnings tax is a penalty tax imposed upon C corporations that accumulate earnings in excess of the reasonable needs of the business, rather than pay them out to shareholders, with the purpose of avoiding taxes at the shareholder level.<sup>23</sup>

The accumulated earnings tax imposed under Section 531 does not apply to a personal holding company within the meaning of Section 542, a foreign personal holding company within the meaning of Section 552, a corporation exempt from tax under Subchapter F, and a passive foreign investment company within the meaning of Section 1296.<sup>24</sup>

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<sup>20</sup> 1411(c)(1)(A)(ii) and (iii).

<sup>21</sup> See Rev. Rul. 59-221, 1951-1 CB 225 and Section 1402(a)(2).

<sup>22</sup> See *Renkemeyer, Campbell & Weaver, LLP v Commissioner*, 136 TC 137 (2011); *Howell v Commissioner*, TC Memo 2012-303; *Riether v Commissioner*, 919 F Supp 2d 1140 (DNM 2012); and CCA 201436049.

<sup>23</sup> Section 531.

<sup>24</sup> Section 532(b).

#### **G. Avoidance of the Personal Holding Company Tax**

S corporations and other pass-through entities are not subject to the Personal Holding Company Tax imposed under Section 541.

A closely held corporation whose income is largely of investment character may be a personal holding company (PHC), in which case a penalty tax is imposed on the “personal holding company income” if not distributed. The personal holding company tax is designed to prevent corporations from accumulating earnings rather than distributing the earnings as taxable dividends.

A corporation is a personal holding company if: (i) at least 60% of its adjusted ordinary gross income (as defined in Section 543(b)(2)) for a taxable year is personal holding company income, and (ii) at any time during the last half of the taxable year, more than 50% in value of the corporation’s stock is owned, directly or indirectly, by or for not more than five individuals.<sup>25</sup>

Personal holding company income generally includes dividends, interest, royalties (including mineral, oil and gas royalties and copyright royalties), annuities, rents, produced film rents, compensation for use of corporate property by shareholders, personal service contract income, and income from estates and trusts.<sup>26</sup> In general, undistributed personal holding company income means “taxable income” (as adjusted by the items set forth in Section 545(b)), less the dividends paid deduction (as defined in Section 561).<sup>27</sup> Adjustments to taxable income generally include negative adjustments for federal income taxes, certain net operating losses, and net capital gains less the attributable taxes.

#### **H. Absence of Limitations on Use of Cash Method of Accounting**

S corporations are not subject to the limitations placed upon C corporations (other than qualified personal service corporations within the meaning of Section 448(d)(2) and C corporations having average annual gross receipts of \$5,000,000 or less) on using the cash method of accounting.

#### **I. Ability to Use Pass-Through Losses to Offset Other Income**

The pass through of losses from an S corporation (or other pass-through entity) to its owners which may be deducted, subject to certain limitations, against the owners’ other income.

#### **J. Avoidance of State Income Taxes**

Some states impose income taxes on C corporations but not on S corporations.<sup>28</sup>

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<sup>25</sup> Section 542(a).

<sup>26</sup> Section 543(a).

<sup>27</sup> Section 545(a).

<sup>28</sup> For example, Florida imposes a 5-1/2% tax on the taxable income of C corporations, while S corporations are subject to tax only on the amounts subject to the built-in gains tax under IRC Section 1374 and the excess net passive investment income tax under IRC Section 1375. Fla Stat Section 220.02, 220.12, and 220.13.

### **III. DISADVANTAGES OF OPERATING A CORPORATION AS AN S CORPORATION (OR OTHER PASS-THROUGH ENTITY) VERSUS A C CORPORATION**

Although there are significant advantages to operating an entity as an S corporation or other pass-through entity rather than as a C corporation, there are several limitations and disadvantages which must be carefully analyzed before making the decision to utilize an S corporation or other pass-through entity rather than a C corporation to operate a business or to convert an existing corporation which is a C corporation to S corporation status or other form of pass-through entity.

#### **A. Limitation on Multiple Classes of Stock**

Unlike S corporations which may only have a single class of stock pursuant to Section 1361(b)(1)(D), C corporations can have multiple classes of stock, including preferred stock. However, partnerships and LLCs taxed as partnerships may have different classes of membership interests, including membership interests providing preferred returns. As such, this is only an advantage that a C corporation has with respect to an S corporation and not with respect to a partnership (LLC).

#### **B. Losses on Small Business Stock**

Generally, losses realized on the sale or other dispositions of corporate stock may only be used to offset capital gains. However, an initial investor whose stock was issued in compliance with the rules of Section 1244 and who later realizes a loss on disposing the stock may reduce his ordinary income (rather than capital gains) by the loss. The ordinary loss treatment, available with respect to both C and S corporation stock, is limited to \$50,000 (\$100,000 for a married couple filing jointly) annually. The requirements of Section 1244 are as follows:

1. At the time the stock is issued, the company's total equity capital does not exceed \$1 million, taking into account amounts obtained through prior stock issuances;
2. For the five previous taxable years (or its entire life if in existence less than five years), the company must have either (1) operated at a loss, or (2) derived more than half of its gross receipts from sources other than rents, interests, dividends, annuities, royalties, and dealings in stocks or securities;
3. The investor must be the initial issuee of the stock (not a transferee) and must be an individual or partnership (not a trust or estate); and
4. The investor must have paid for the stock in money or other property (other than stock and securities).

#### **C. Exclusion of Gain on Qualified Small Business Stock**

Section 1202 permits individual shareholders to exclude from gross income 100% of gains they realize from the sale or exchange of "qualified small business stock" held for more than five years. Unlike Section 1244, this provision applies only to C corporations (which must meet certain other requirements). The exclusion is not permitted if, within two years before and after issuance,

the company purchased any of its stock from a shareholder or a person related to the shareholder, or if, within one year before and after issuance, the company purchased its stock having a value of more than 5% of the aggregate value of all of outstanding stock (determined as of one year before the purchase). However, if the gain qualifies for the 100% exclusion under Section 1202, the balance is subject to capital gain rate of 28%, rather than 15% that typically applies to long term capital gain. Also, a portion of the gain excluded is a tax-preference item includible in the alternative minimum tax computation. The amount excluded from gross income was 50% when Section 1202 was enacted. Under the American Recovery and Reinvestment Act of 2009, the Section 1202 exclusion was increased to 75% for stock acquired after February 17, 2009 and before January 1, 2011. The Small Business Jobs Act of 2010 increased the exclusion to 100% which was eventually made permanent by the Protecting Americans from Tax Hikes Act ("PATH Act"). Additionally, the subsequent law changes eliminate any portion of the excluded gain as a tax preference item.

**D. Shareholder Level Tax on Undistributed Income**

Unlike pass-through entities with respect to which the income of the entity is taxed at the owner level whether distributed or not, there is no shareholder level tax on the undistributed income of a C corporation. Consequently, if a C corporation does not distribute its income to its shareholders, there is no shareholder level tax on such undistributed income. However, in such cases, the C corporation could potentially be subject to the Accumulated Earnings Tax imposed under Section 531 or the Personal Holding Company Tax imposed under Section 541.

**E. Benefit of Lower Corporate Tax Rates**

For entities that will have lower income, such entities will benefit from the lower corporate tax rates rather than the higher income tax rates applicable to individuals set forth above.

**F. Limitations on Filing Consolidated Returns**

If a corporation directly or indirectly controls one or more other corporations, and the controlling corporation and the controlled corporations together are an "affiliated group," the group may qualify to file a single consolidated corporate income tax return, in place of separate returns for each corporation. The separate incomes of the corporations joining in the consolidated return are totaled. The deductions are similarly totaled. Thereafter, the total or consolidated deductions are subtracted from the total or consolidated income, leaving consolidated taxable income. Next the consolidated tax is computed in the same manner as if the consolidated return were that of a single corporation. Finally, any tax credits are computed, also on a consolidated basis, and deducted from the consolidated tax to arrive at the consolidated corporate tax liability. However, for most corporate groups that file consolidated returns, special rules apply to various items including: intercompany transactions, inventories, basis of assets acquired by one member from another and of intercompany investments, capital gains and losses, operating losses, losses on dispositions of subsidiary stock, and basis of subsidiary stock on its deconsolidation, and earnings and profits available for payment of dividends. S corporations cannot file consolidated returns with C corporations as an S corporation is not an "includible corporation."



## **G. Loss of Tax-Free Fringe Benefits**

One disadvantage of operating a corporation as an S corporation rather than as a C corporation, is the inability of certain S corporation shareholders to exclude from their gross incomes the value of certain statutory fringe benefits. Under Section 1372(a), an S corporation is treated as a partnership, and any “2% shareholder” of an S corporation is treated as a partner of such partnership, for purposes of applying the provisions of the Code relating to employee fringe benefits. Section 1372(b) provides that the term “2% shareholder” means any person who actually or constructively (within the meaning of Section 318) owns on any day during the taxable year of the S corporation *more than 2%* of the outstanding stock of such corporation or stock possessing *more than 2%* of the total combined voting power of all stock of such corporation. The effect of this rule is to preclude a 2% shareholder from excluding the value of corporate-provided fringe benefits from income because such benefits are only excludable by “employees,” which for purposes of corporate-provided fringe benefits does not include partners of a partnership.<sup>29</sup> Specifically, a 2% shareholder is subject to the following limitations:

1. A 2% shareholder may not exclude from his or her income the value of benefits received pursuant to corporate-provided health and accident insurance nor the value of corporate contributions for the cost of corporate-provided health and accident plans under Section 105 and Section 106.
2. A 2% shareholder may not exclude from his or her income the value of the first \$50,000 of corporate-provided group-term life insurance under Section 79(a).
3. A 2% shareholder is not entitled to exclude from his or her income the value of meals and lodging furnished for the convenience of the employer under Section 119.
4. A 2% shareholder is not eligible for the benefits of a medical reimbursement plan.

## **H. S Corporation Eligibility Restrictions**

An S corporation is defined as a “small business corporation” for which an election under Section 1362(a) is in effect for such year.<sup>30</sup> The term “small business corporation” is defined as a “domestic corporation” which is not an “ineligible corporation” and which does not have: (1) more than 100 shareholders; (2) as a shareholder a person (other than an estate or certain types of trusts) who is not an individual; (3) a non-resident alien as a shareholder; and (4) more than one class of stock.<sup>31</sup> The term “domestic corporation” means a corporation that is created or organized in the United States or under the laws of the United States or of any state or territory thereof.<sup>32</sup> The term “ineligible corporation” means any corporation which is a member of an affiliated group as defined in Section 1504, a financial institution, an insurance company, a possessions corporation, or a

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<sup>29</sup> See, e.g., Sections 79(a), 105(a), 106 and 119(a). See also, Sections 401(c) and 1402(a).

<sup>30</sup> Section 1361(a)(1).

<sup>31</sup> Section 1361(b)(1).

<sup>32</sup> Section 7701(a)(3) and (4).

DISC or former DISC.<sup>33</sup> A husband and wife (and their estates) are treated as one shareholder.<sup>34</sup> Section 1361(c)(2) and (d) prescribe the types of trusts which may be shareholders of an S corporation. For the typical professional corporation, the only eligibility requirement which might pose a problem is the limitation that the S corporation have no more than 100 shareholders.

Some law firms and accounting firms, as well as other professional corporations, will have more than 100 shareholders, and as such, would be precluded from operating their professional corporation as an S corporation. One possible solution to this problem is for each individual member to separately incorporate as an S corporation and form a partnership of S corporations. In this situation, however, it will be necessary to show an independent business purpose for forming the partnership of S corporations, such as limitation of liability, or the IRS may apply Revenue Ruling 77-220<sup>35</sup> to disregard the S elections of the corporate partners.<sup>36</sup>

## **I. Limitations on Taxable Year**

An S corporation must have a "permitted taxable year" which is either a calendar year, a fiscal year for which the corporation establishes a sufficient business purpose, or a fiscal year permitted pursuant to an election under Section 444.<sup>37</sup> Section 444 permits an S corporation to elect a taxable year different from that required under Section 1378 provided that such taxable year does not result in a deferral of greater than three months and provided that the corporation makes the tax payments required under Section 7519 for each year the election is in effect. An S corporation electing under Section 444 must make annual payments to the IRS for approximately the same amount of taxes as the shareholders would have paid if the corporation were on a calendar taxable year. The payments are due on or before May 15 following the calendar year in which the election year begins.<sup>38</sup>

Although C corporations may generally choose any taxable year, if the C corporation meets the definition of a "personal service corporation,"<sup>39</sup> the taxable year of such corporation must be the calendar year unless the corporation establishes a business purpose for having a different period for its taxable year, or elects a fiscal taxable year under Section 444. Section 444 permits a personal service corporation to elect a taxable year other than a required taxable year provided that such taxable year does not result in a deferral of greater than three months and provided that the personal service corporation complies with the Section 280H limitation on the deduction of compensation paid to employee-owners. Consequently, with respect to professional corporations which would (or do) constitute personal service corporations for purposes of the taxable year limitation, such corporations, whether operated as an S corporation or a C corporation, will generally be required to have a calendar taxable year unless a Section 444 election is made by the corporation and it complies with either Section 7519 in the case of an S corporation or Section 280H in the case of a C corporation. As such, there is no clear advantage to operating the service

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<sup>33</sup> Section 1361(b)(2).

<sup>34</sup> Section 1361(c)(1).

<sup>35</sup> 1977-1 CB 263.

<sup>36</sup> See Ltr Ruls 9026044, 9017057, and 8950066, in which the IRS approved the formation of partnerships of S corporations where an independent business purpose for the formation of the partnerships was present.

<sup>37</sup> Section 1378.

<sup>38</sup> Section 7519(b).

<sup>39</sup> Within the meaning of Section 441(i)(2).

corporation as a C corporation or as an S corporation. Where the service corporation does constitute a personal service corporation for purposes of the taxable year limitation, however, the C corporation offers far more flexibility than does the S corporation.

**J. Tax Costs of Converting From C to S Status or Liquidation**

Although a corporation which converts from C corporation to S corporation status may enjoy considerable tax and other benefits attributable to its S status, the conversion process is fraught with potential pitfalls. These include the potential imposition of the excess passive investment income tax under Section 1375 and the possible termination of the S election under Section 1362(d), the imposition of the LIFO recapture tax under Section 1363(d), the potential application of the distribution rules applicable to S corporations having subchapter C earnings and profits under Section 1368(c), the loss of net operating loss carryovers under Section 1371(b) and the imposition of the built-in gain tax under Section 1374. Generally, the greatest exposure facing a corporation upon conversion to S corporation status is the imposition of the built-in gain tax under Section 1374. This problem will be especially acute with respect to the corporation that reports its income under the cash method of accounting. A brief discussion of the mechanics of the built-in gain tax will ensue and will be followed by an examination of the special problems facing the cash-basis corporation converting to S corporation status.

**IV. DISADVANTAGES OF OPERATING AS AN LLC VERSUS AN S CORPORATION**

**A. Employment Tax**

As discussed above, provided an S corporation pays reasonable compensation to its shareholder-employees, there are opportunities for significant employment tax savings by making S corporation distributions to the shareholder-employees.

The self-employment tax ("SE Tax") can be a significant burden on taxpayers as it is imposed on net earnings from self-employment ("NESE") at the rate of 15.3% on the first \$118,500 of such net earnings, and 2.9% (or 3.8% on the net investment income of certain individuals as previously discussed above) on amounts in excess of \$118,500 for 2016.<sup>40</sup> Excluded from the definition of NESE are certain capital gains, rental income, interest and dividends. Because individuals are entitled to an above the line deduction equal to one-half of the SE Tax paid under Section 164(f), the effective tax rate for the SE Tax is somewhat reduced.

As discussed above, beginning in 2013, the HI portion of the Social Security tax was increased from 2.9% to 3.8% for wages in excess of \$250,000 for married individuals filing jointly and in excess of \$200,000 for other taxpayers. Additionally, as discussed above, beginning in 2013, taxpayers having modified adjusted gross income in excess of \$250,000 in the case of married individuals filing jointly and \$200,000 for other taxpayers was subject to the 3.8% Medicare tax on their net investment income.

The SE Tax treatment of general partners is generally understood: each general partner must include as NESE his distributive share of ordinary income (other than the excluded interest,

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<sup>40</sup> Section 1402(a).

rent and dividends). Section 1402(a)(13) excludes from NESE a limited partner's distributive share of partnership income (other than distributions that are guaranteed payments or compensation for services to the extent that those payments are established to be in the nature of remuneration for those services to the partnership). Accordingly, a general partner's distributive share of income from the partnership normally *will be* treated as NESE, while a limited partner's distributive share of income from the partnership normally *will not be* treated as NESE. The legislative history of Section 1402 makes clear that this exception for limited partners was intended to prevent passive investors, who do not perform services, from obtaining social security coverage or coverage under qualified retirement plans. One troubling issue relates to the application of the SE Tax with respect to a limited partner who also serves as a general partner in a partnership. Section 1402's legislative history reflects an intent to apply these rules separately to limited partnership and general partnership interests, even if held by the same partner. The lack of legislative or regulatory clarity has caused the application of rules for limited partners to be difficult.

While multi-member LLCs (which do not elect to be treated as associations taxable as corporations) are treated as partnerships for tax purposes under the Check-the-Box Regulations, the SE Tax issues relating to LLCs and their members are at best unclear. The question to be addressed is whether members of such LLCs (taxed as partnerships) would be treated as limited partners under Section 1402(a)(13), so that their distributive share of LLC income and loss relating to their LLC interest is exempt from SE Tax.

On its face, the language of Section 1402(a)(13) would only exclude from NESE the distributive share of income *of a limited partner* of a partnership. Under such a literal reading, the distributive share of income of any other type or class of partner in the partnership would be considered NESE. Rev. Rul. 58-166,<sup>41</sup> held that the taxpayer's earnings from a working interest in an oil lease was NESE despite the fact that he had limited involvement in the organization.

In *Thompson v. United States*,<sup>42</sup> the United States Court of Federal Claims held that *an LLC member could not be treated the same as a limited partner* for purposes of meeting the material participation rules under the passive activity loss limitation rules of Section 469.

The taxpayer-member formed Mountain Air Charter, LLC ("Mountain Air") under the laws of the state of Texas. The taxpayer directly owned a 99% membership interest in Mountain Air and indirectly held the remaining 1% through an S corporation. Mountain Air's Articles of Organization designate the taxpayer-member as its only manager. Because Mountain Air did not elect to be treated as a corporation for federal income tax purposes, by default it was taxed as a partnership.<sup>43</sup> On his 2002 and 2003 individual income tax returns, the taxpayer-member claimed Mountain Air's losses of \$1,225,869 and \$939,870, respectively. The IRS disallowed the losses because it believed that the taxpayer did not materially participate in the business operations of Mountain Air.

Specifically, the IRS rested its conclusion on Reg. § 1.469-5T, which sets forth the tests for what constitutes taxpayer material participation for purposes of applying the passive activity

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<sup>41</sup> 1958-1 C.B. 224.

<sup>42</sup> 87 F. Cl. 728 (2009).

<sup>43</sup> Reg. § 301.7701-3(b)(1)(i).

loss limitation rules of Section 469. The IRS found that Reg. § 1.469-5T “explicitly treats interests in any entity which limits liability as limited partnership interests.” Because the taxpayer enjoyed limited liability as a member of his limited liability company (Mountain Air), the IRS concluded that the taxpayer’s interest was identical to a limited partnership interest. The taxpayer, on the other hand, argued that his membership interest should not be treated as a limited partnership interest for purposes of the passive activity loss limitation rules. The classification of a membership interest in an LLC as a “limited partnership interest” is important because a limited partner has fewer means by which he can demonstrate his material participation in the business. The parties specifically stipulated that if the taxpayer’s membership interest is a limited partnership interest, then the taxpayer cannot demonstrate his material participation in the LLC and Section 469 will limit his losses. Likewise, the parties also stipulated that if the taxpayer’s membership interest is *not* a limited partnership interest, then the taxpayer can demonstrate his material participation in the LLC and Section 469 does *not* limit his losses.

The taxpayer simply argued that his interest should not be treated as a limited partnership interest because Mountain Air was *not* a limited partnership. The IRS, on the other hand, argued that it was proper to treat the taxpayer’s interest in Mountain Air as a limited partnership interest because the taxpayer elected to have Mountain Air taxed as a partnership for federal income tax purposes and the taxpayer’s liability was limited under the laws of the state in which it was organized (Texas).

Based on the plain language of both the statute and the regulations, the court concluded that in order for an interest to be classified as a limited partnership interest the ownership interest must be in an entity that is, in fact, a partnership under state law and not merely taxed as such under the Code. Specifically, the court stated that once Reg. § 1.469-5T(e)(3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply inapplicable to a membership interest in an LLC.

Furthermore, the court found that even if Reg. § 1.469-5T(e)(3) could apply to the taxpayer and the court had to categorize his membership interest as either a limited or general partnership interest, it would best be categorized as a general partner’s interest under Reg. § 1.469-5T(e)(3)(ii) since a member in an LLC can actively participate in the management of the LLC (unlike limited partners of a limited partnership).

In Action on Decision 2010-14,<sup>44</sup> the IRS announced its acquiescence in result only in *Thompson*. In addition to *Thompson*, *Garnett v. Commissioner*,<sup>45</sup> *Gregg v. U.S.*,<sup>46</sup> and *Newell v. Commissioner*,<sup>47</sup> have all ruled against the IRS’s position that an interest in an LLC is a limited partnership interest under Reg. § 1.469-5T(e)(3)(i).

In *Robucci v. Commissioner*,<sup>48</sup> the Tax Court applied the two-pronged *Moline Properties*<sup>49</sup> test to disregard two corporations created by a psychiatrist (on the advice of his accountant) for

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<sup>44</sup> I.R.B. 515 (April 5, 2010).

<sup>45</sup> 132 TC 19 (2009).

<sup>46</sup> 186 F.Supp.2d 1123 (D. Or. 2000).

<sup>47</sup> TC Memo. 2010-23.

<sup>48</sup> TCM 2011-19.

<sup>49</sup> *Moline Properties v. Commissioner*, 319 U.S. 436, 30 AFTR 1291 (1943).

the purpose of reducing his tax liabilities. The court also imposed an accuracy-related penalty under Section 6662(a) for a substantial understatement of income tax.

The taxpayer met with his advisor to explore the benefits of incorporating his practice, including minimizing taxes. The taxpayer's advisor, who was an attorney and certified public accountant (CPA), had an accounting practice that specialized in small businesses. "Choice of entity planning" for those businesses was a significant part of the advisor's practice.

The taxpayer's advisor recommended an organizational structure designed to transform the taxpayer's sole proprietorship into a limited liability company (LLC) classified as a partnership for federal income tax purposes with the intent of reducing self-employment tax. In particular, the LLC would have two members: the taxpayer, who would have a 95% interest, and a newly incorporated personal corporation ("Robucci P.C."), which was designated the manager of the LLC with a 5% interest. The taxpayer's 95% interest was split between an 85% interest as a limited partner and a 10% interest as a general partner. The case does not explain how the LLC could have partners classified as "general partners" and "limited partners." It is unclear why the advisor didn't use a single limited partnership as the choice of entity for the taxpayer. The 85% limited partner interest allegedly represented goodwill, the value of which was determined by the taxpayer's advisor but unsupported by any documentation. A second corporation ("Westphre") was formed for the purpose of providing services in connection with the taxpayer's practice, including its management and tracking its expenses and to creating a group eligible for medical insurance. Westphre charged the LLC "management fees" for its alleged services.

The taxpayer's advisor provided no written explanation of the reason for creating three entities and he never discussed with the taxpayer the basis for the 85%/10% split between his "limited" and "general" partnership interests. The taxpayer did not seek a second opinion from any other CPA or attorney assessing the merits of his advisor's recommendations. There was no valuation in support of the 85% limited partnership interest issued for intangibles, nor was there a written assignment of the tangible or intangible assets of the taxpayer's medical practice to the LLC.

The taxpayer paid self-employment tax only on net income allocated to him as general partner (i.e., 10% of LLC's net income), whereas, as a sole proprietor, he was required to pay self-employment tax on the entire net income from his psychiatric practice.<sup>50</sup>

The court analyzed the facts under the two-prong test of *Moline Properties*. Under this test, a corporation is recognized as a separate legal entity if either: (a) the purpose of its formation is the equivalent of business activity, or (b) the incorporation is followed by the carrying on of a business by the corporation.

Under the first prong, the court found that both Robucci P.C. and Westphre were formed solely to reduce the taxpayer's tax liability and not with a business purpose (i.e., there was no equivalent of business activity on corporate formation). With respect to Westphre, the court concluded that its only activity was the equivalent of "taking money from one pocket and putting it into another." Under the second prong of the *Moline Properties* test, the court found that both

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<sup>50</sup> See Section 1401 and 1402.

entities “were, essentially, hollow corporate shells,” which lead to the conclusion that “neither carried on a business after incorporation.” Thus, the court disregarded both corporations.

Because Robucci P.C. was disregarded for tax purposes, the court found that the LLC had only one owner, the taxpayer. Because no election was made to classify the LLC as a corporation, the LLC was disregarded<sup>51</sup> and its owner was treated as a sole proprietor. Consequently, the taxpayer was treated as a sole proprietor for federal tax purposes, which was his status before formation of the three entities.

In *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*,<sup>52</sup> the Tax Court disallowed a law firm’s special allocation of business income and held that the firm’s attorney partners were liable for self-employment tax on allocations of partnership income related to the law firm’s legal practice.

Renkemeyer, Campbell & Weaver, LLP is a Kansas law firm. During the 2004 tax year, the firm’s partners included three attorneys and RCGW Investment Management, Inc., a subchapter S corporation that was wholly owned by an Employee Stock Ownership Plan and Trust (the “ESOP”) benefiting the three attorneys. The law firm timely filed its partnership tax return for the 2004 tax year, which allocated 87.557% of the law firm’s net income to the ESOP. The IRS issued an FPAA for tax years 2000, 2001, and 2002 to the law firm, which:

- (a) Disallowed the special allocation to the ESOP and determined that net business income should be reallocated to the partners consistent with the profit and loss sharing percentages reported on the partners’ respective Schedules K-1.
- (b) Determined that the partners’ distributive shares of the law firm’s net business income were subject to self-employment tax.

Although the law firm asserted that the special allocation to the ESOP was proper under the partnership agreement, it could not produce a copy of the partnership agreement for the record. Therefore, the court looked to the partners’ respective interests in the partnership to determine whether the special allocation had economic reality. Based on an analysis of relative capital contributions, distribution rights, and profit and loss sharing percentages, the court concluded that the special allocation of the law firm’s net business income for the 2004 tax year was improper and should be disallowed.

Section 1402(a) provides several exclusions from the general self-employment tax rule, including an exclusion under Section 1402(a)(13) for the distributive share of any item of income or loss of a limited partner (other than guaranteed payments in the nature of remuneration for services). Because the term “limited partner” is not defined in the statute, the court had to determine whether an attorney partner who provides services in a law firm structured as a limited liability partnership can be treated as a “limited partner” for purposes of the exclusion under Section 1402(a)(13).

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<sup>51</sup> See Reg. § 301.7701-1 through -3.

<sup>52</sup> 136 TC 137 (2011).

The court examined the statute's legislative history, which revealed that the intent of Section 1402(a)(13) was to ensure that individuals who merely invest in a partnership and do not actively participate in the partnership's business operations (which was the archetype of limited partners at the time) do not receive credits toward Social Security coverage. The court determined that the legislative history did not contemplate excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons) from liability for self-employment taxes. Because nearly all of the law firm's revenues were derived from legal services performed by the attorney partners in their capacities as partners, the court determined that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not "earnings which are basically of an investment nature." Therefore, the court held that the attorney partners' distributive shares arising from legal services they performed on behalf of the law firm were subject to self-employment taxes. Because the law firm was formed as a limited liability partnership rather than a limited partnership, it did not actually have "limited" or "general" partners as would a limited partnership.

In *Howell v. Commissioner*,<sup>53</sup> the Tax Court held a couple liable for self-employment tax under Section 1401 on payments made to the wife by their LLC, finding that the couple could not disavow the reporting position they took on the company's returns by later arguing the payments were partnership distributions rather than guaranteed payments.

In *Howell*, the taxpayers, husband and wife, formed a California limited liability company to provide software and hardware to hospitals consisting of a remote access system that enabled doctors to access hospital records from outside the hospital. When the LLC was first organized, Mr. Howell decided to make Mrs. Howell a member of the LLC rather than himself for various reasons. On the LLC's tax returns, the LLC treated the amounts in issue as guaranteed payments to Mrs. Howell. The taxpayers later argued that these guaranteed payments actually represented distributions from the LLC to Mrs. Howell on which no self-employment tax was owed.

The specific issue is whether members of such LLCs (taxed as partnerships) should be treated as limited partners under Section 1402(a)(13), so that their distributive share of LLC income and loss is exempt from the self-employment tax, or whether they should be treated as general partners so that their distributive share of LLC income and loss is subject to the self-employment tax.<sup>54</sup>

In its decision, the Tax Court cited its earlier decision in *Renkemeyer*, for the proposition that the legislative history of Section 1402(a)(13) does not contemplate excluding partners who perform services for a partnership in their capacity as partners from liability for self-employment taxes, and that the Section 1402(a)(13) exemption was only meant to exclude from self-employment income the distributive share of individuals who merely invested in the partnership and who were not actively participating in the partnership's business operations, and whose distributive shares were earnings "basically of an investment nature." Specifically, the court in *Renkemeyer* held that the taxpayers were not limited partners for purposes of Section 1402(a)(13)

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<sup>53</sup> TC Memo 2012-303.

<sup>54</sup> The treatment of LLC members for self-employment tax purposes has been an issue the IRS has struggled with for many years. See eg, Prop Reg. § 1.1402(a)(18) (issued in 1994 and later withdrawn); and Prop Reg. § 1.1402-2(h) (issued in 1997 but never finalized).



because the distributive shares received arose from legal services performed on behalf of the law firm by the taxpayers and did not arise as a return on the taxpayers' investment in the law firm.

The Tax Court first found that even if they allowed the taxpayers to disavow the form of the transaction adopted on the LLCs returns (i.e., as guaranteed payments), the taxpayers must offer strong proof to show that the reporting was incorrect, which the taxpayers failed to do.

Additionally, based on the *Renkemeyer* case, the court found that Mrs. Howell performed services for the LLC and was not merely a passive investor, and as such, could not be treated as a limited partner under Section 1402(a)(13).

The *Howell* case, as well as the Tax Court's prior decision in *Renkemeyer*, indicate that it will be difficult for an LLC member to be treated as "limited partner" under Section 1402(a)(13) for purposes of excluding his or her distributive share of the income of the LLC from the self-employment tax any time such member provides services to or on behalf of the LLC and who is characterized other than as a passive investor of the LLC. This should be contrasted with a shareholder of an S corporation who materially participates in the business, where only amounts paid as reasonable salary should be subject to Social Security taxes on such wages, and the shareholder's distributive share of the income of the S corporation and all dividend distributions should be exempt from the self-employment tax and Social Security taxes by reason of Revenue Ruling 59-221<sup>55</sup> and Section 1402(a)(2). An S corporation shareholder who materially participates in an active trade or business carried on by an S corporation should also not be subject to the new tax imposed on net investment income with respect to such shareholder's distributive share of the S corporation's income by virtue of Section 1411(c)(2)(A).<sup>56</sup>

In *Riether v. Commissioner*,<sup>57</sup> the court rejected on summary judgment a radiologist's and his wife's claim that they were not liable for self-employment tax on their distributive share of income from a diagnostic imaging LLC taxed as a partnership. Although not clear from the facts of the case, presumably all of the income of the diagnostic imaging LLC was attributable to the "facility fee or "technical component" of the imaging services provided by the LLC rather than for professional medical (reading) services.

The LLC actually issued W-2s to the husband and wife showing salaries or wages paid by the LLC to each of them for a portion of the LLC's income. For the balance of the LLC's income, K-1s were issued to the husband and wife on which they did not pay self-employment tax.

Citing Revenue Ruling 69-184,<sup>58</sup> the court stated that the LLC should have treated all of the LLC's income as self-employment income, rather than characterizing some of it as wages. Specifically, Revenue Ruling 69-184 states that members of a partnership are not employees of the partnership for purposes of self-employment taxes. Rather, a partner who participates in the

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<sup>55</sup> 1959-1 CB 225.

<sup>56</sup> The Health Care and Education Reconciliation Act of 2010, HR 4872, P L No 111-152, imposes a 3.8% tax on the lesser of (a) net investment income or (b) the excess of modified adjusted gross income over \$250,000 in the case of taxpayers filing a joint return and over \$200,000 for other taxpayers. The definition of net investment income is quite expansive for purposes of the new 3.8% tax imposed under IRC Section 1411(a)(1).

<sup>57</sup> 919 F Supp 2d 1140 (DNM 2012).

<sup>58</sup> 1969-1 CB 256.

partnership business is “a self-employed individual.” The court found that the LLC’s improper treatment of the “wages” income further undermined the taxpayers’ simplistic argument that they owed no self-employment taxes simply because they received W-2s.

The taxpayers also argued that the income of the LLC was “unearned income,” and as such, was not subject to the self-employment tax. The court stated that simply labeling income as “unearned income” does not exempt such amounts from the self-employment tax. Rather, the court reiterated that the self-employment tax applies to a taxpayer’s distributive share of all partnership income with only certain limited exceptions. Citing Section 1402(a)(13), which exempts from the self-employment tax a limited partner’s distributive share of income from a limited partnership, and the *Renkemeyer v. Commissioner*<sup>59</sup> case, the court concluded that the taxpayers were not members of a limited partnership, nor did they resemble limited partners, which are those who “lack management powers but enjoy immunity from liability for debts of the partnership.” Thus, whether the taxpayers were active or passive in the production of the LLC’s earnings, those earnings were self-employment income, subject to the self-employment tax.

In CCA 201436049<sup>60</sup> (September 5, 2014), the IRS found that members of a management company LLC (“Management Company”) were not “limited partners” within the meaning of Section 1402(a)(13) and therefore were subject to the self-employment tax on their distributive shares of income of Management Company.

Under the facts of the ruling, a limited liability company classified as a partnership for federal tax purposes served as the investment manager for “Managed Fund,” a family of investment partnership funds that carry on extensive trading and investing activity (the “Funds”). Management Company generally has full authority and responsibility to manage and control the affairs and business of the Funds. Management Company is primarily responsible for carrying out the extensive market research and trading activity of each of the Funds, and carries on all investment activities, such as the purchasing, managing, restructuring and selling of the Funds’ investment assets. Members of Management Company and its employees provide these extensive services to the Funds. Management Company’s primary source of income is from fees for providing management services to the Funds. In consideration of Management Company’s services, the limited partnership agreements of each of the Funds provide for payment of a quarterly “management fee” from the Funds to Management Company. For the years in issue, Management Company’s gross receipts were entirely attributable to management fees for providing services to the Funds, and Management Company’s ordinary business income was comprised entirely of income from management fees.

Additionally, in the years in issue, each member of Management Company worked full time for Management Company, performing a wide-range of professional services. Each of the members received a Form W-2 from Management Company for specified wage amounts.

For the years in issue, Management Company treated all of its members as “limited partners” not subject to the self-employment tax on their distributive share of Management

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<sup>59</sup> 136 TC 137 (2011). In *Renkemeyer*, the Tax Court disallowed a law firm’s special allocation of business income and held that the firm’s attorney partners were liable for self-employment tax on allocations of partnership income related to the law firm’s legal practice.

<sup>60</sup> September 5, 2014.

Company's income. The only amounts reported as subject to self-employment tax were guaranteed payments representing health insurance premiums and parking benefits paid on behalf of the members by Management Company.

The ruling also cites the *Riether* case, where the court granted the government's motion for summary judgment on the issue of whether a husband and wife were subject to self-employment tax on their distributive share of income from an LLC. In the *Riether* case, the court concluded that Section 1402(a)(13) only applies to limited partners and not to taxpayers treated as a general partner, "*irrespective of the nature of his membership.*" The court went on to find that the taxpayers were not members of a limited partnership, nor did they resemble limited partners, which are those who "*lack management powers but enjoy immunity from liability for debts of the partnership.*" The *Riether* case concluded that *whether the taxpayers were active or passive in the production of the LLC's earnings, those earnings were self-employment income subject to the self-employment tax.*

The ruling provides that Management Company's members performed extensive investment and operational management services for Management Company in their capacity as members (i.e., acting in the manner of self-employed persons) and that Management Company derives its income from the investment management services performed by its members. The IRS concluded that the income earned by the members through Management Company was not income which was "basically of an investment nature" of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to Section 1402(a)(13). Additionally, the IRS stated that like the situation in *Renkemeyer*, the members' earnings were not in the nature of a return on capital investment, even though the members paid more than a nominal amount for their membership interests. Rather, the IRS found that the earnings of each member from Management Company were a direct result of the services rendered on behalf of Management Company by such members. The IRS also stated that similar to *Riether*, Management Company cannot change the character of its members' distributive shares by paying a portion of each member's distributive share as amounts mislabeled as so-called "*wages*," citing Revenue Ruling 69-184.<sup>61</sup>

Finally, the IRS expressly stated that because Management Company was not an S corporation, the "*reasonable compensation*" rules applicable to S corporations did *not* apply to Management Company which was an LLC taxed as a partnership.<sup>62</sup>

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<sup>61</sup> 1969-1 CB 256. Rev Rul 69-184 expressly provides that a partner of a partnership cannot be treated as an employee for employment tax purposes. Consequently, the court in *Riether* and the IRS in CCA 201436049 found that the LLCs incorrectly issued W-2s to their members since they could not be treated as employees.

<sup>62</sup> Neither a shareholder's distributive share of income passed through from the S corporation under IRC Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute net earnings from self-employment subject to the self-employment tax. See Rev Rul 59-221, 1959-1 CB 225, in which the IRS found that an S corporation's income does not constitute net earnings from self-employment for purposes of the self-employment tax, and IRC Section 1402(a)(2), which specifically excludes from the definition of net earnings from self-employment dividends on shares of stock issued by a corporation. Consequently, as long as S corporations pay "reasonable compensation" to their shareholder-employees, the balance of the earnings of an S corporation distributed as dividends should be excluded from employment and Social Security taxes. See, e.g., *Radtke v US*, 895 F2d 1196 (7th Cir 1990); *Spicer Accounting, Incorporated v US*, 918 F2d 90 (9th Cir 1990); and *David E Watson PC v US*, 668 F3d 1008 (8th Cir 2012).

## **B. Partners Cannot be Employees**

On June 13, 2014, Curtis Wilson, IRS Associate Chief Counsel (Passthroughs and Special Industries) stated that he is concerned about the rumored use of a disregarded entity to enable a partner to be treated as an employee for withholding purposes.<sup>63</sup> Under the purported structure, a partnership creates a wholly-owned entity that is disregarded for federal income tax purposes, and has the partners of the partnership become employees of the disregarded entity, which for employment tax purposes, is treated as the employer having its own employer identification number and subject to Form W-2 withholding. Wilson stated that the IRS is looking at this issue but that if the use of a disregarded entity works, “it makes it pretty easy to get around what would otherwise be the general rule, and so ... we think it’s a stretch.” The general rule Wilson is referring to is that contained in Revenue Ruling 69-184,<sup>64</sup> which states that an individual cannot both be an employee and a partner of the same partnership.

Additionally, Clifford Warren, Special Counsel to the IRS Associate Chief Counsel (Passthroughs and Special Industries) cited the recent *Riether*<sup>65</sup> case which confirmed the holding in Revenue Ruling 69-184 that if an individual is a partner, he cannot be an employee of the partnership. Based on the *Riether* case confirmation of Revenue Ruling 69-184 and on the purported use of disregarded entities as a way to treat a partner of a partnership as an employee.

## **C. Reorganization Provisions**

### **1. Tax-Free Reorganizations are Limited to Corporations**

By complying with the reorganization provisions prescribed under Section 368(a), owners of an S corporation can effectively “sell” their S corporation to another corporation and receive stock in that corporation, including preferred stock, without incurring any federal income tax.<sup>66</sup>

### **2. Partnerships Not Eligible for Tax-Free Reorganization Treatment**

In contrast, a similar transaction undertaken by a partnership would result in a taxable transaction.

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<sup>63</sup> See Elliot, “IRS Concerned About Dual Partner/Employee Workaround,” 2014 TNT 115-8 (June 16, 2014).

<sup>64</sup> 1969-1 CB 256.

<sup>65</sup> 919 F Supp 2d 1140 (DNM 2012). For a discussion of the *Riether* case, see Klein and Looney, “Income from Diagnostic Imaging Subject to Self-Employment Tax,” 16 BET 46 (January/February 2014).

<sup>66</sup> See *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (Acquisition for cash (representing 62% of the exchange consideration) and non-voting preferred stock (representing 38% of the exchange consideration) qualified as a reorganization).

(a) Incorporation of the Partnership. A possible way to address the “corporate” requirements of Section 368 is to incorporate the partnership.<sup>67</sup> The IRS will analyze the tax effects of the partnership incorporation in accordance with its form.<sup>68</sup>

(b) Liabilities in Excess of Basis. Under Section 357(c), if the partnership’s liabilities exceed the aggregate basis of the transferred assets, the transferor recognizes gain equal to the amount of such excess.

(c) Step-Transaction. In many cases, the desirability of incorporating the LLC/partnership may not become apparent until a potential suitor and transaction have materialized. These situations are problematic from the taxpayer’s perspective because they are subject to attack, particularly under step-transaction analysis or Court Holding analysis.<sup>69</sup>

In Rev. Rul. 70-140,<sup>70</sup> A, an individual, owned two businesses, one of which was owned by X, a wholly owned corporation, and a similar business operated as a sole proprietorship. Pursuant to an agreement between A and Y, an unrelated corporation, A transferred the sole proprietorship to X, for additional stock and then transferred all of his X stock to Y solely in exchange for Y voting stock which was widely held. The ruling holds the steps were part of a prearranged plan and that the transfer of the sole proprietorship to X would not be respected since it was merely a transitory step without substance for tax purposes. The transaction was recast as a taxable sale of the sole proprietorship assets to Y, followed by Y’s drop down of the assets to X.<sup>71</sup>

#### **D. Cancellation of Debt/Insolvency**

Although the analysis is complicated, in many cases involving a financially distressed entity, the tax consequences to an owner of an S corporation may be more favorable than that of an owner of a partnership.

Under Section 108(d)(7), subsections (a) (exclusion from gross income), (b) (reduction of tax attributes), (c) treatment of discharge of qualified real property business indebtedness and (g) qualified farm indebtedness, of Section 108 are applied at the corporate level. Thus, for example, for purposes of the insolvency exclusion under Section 108(a)(1)(B), solvency is determined at the

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<sup>67</sup> See Rev. Rul. 84-111, 1984-2 C.B. 88 (which addresses three different forms for incorporating a partnership: (1) transfer by partnership of its assets and liabilities to corporation in exchange for stock of corporation followed by liquidation of partnership and distribution of stock to partners; (2) liquidation of partnership followed by transfer by partners of assets and liabilities received from liquidating partnership to corporation in exchange for stock of corporation; and (3) transfer by partners of their partnership interests to corporation in exchange for stock of corporation with partnership terminating upon transfer).

<sup>68</sup> See also Rev. Rul. 2004-59, 2004-24 IRC 1050 (conversion of partnership to corporation utilizing state formless conversion statute treated as partnership contributing all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter liquidating and distributing the stock of the corporation to its partners), and Reg. §301.7701-3(g)(1)(i) (check the box incorporation treated as partnership contributing its assets to corporation in exchange for stock of corporation and then liquidating).

<sup>69</sup> Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

<sup>70</sup> 1970-1 C.B. 73.

<sup>71</sup> See also West Coast Marketing Corp. v. Commissioner, 46 TC 32 (1966).

level of the S corporation. With respect to a partnership, under Section 108(d)(6), subsections (a), (b), (c) and (g) of Section 108 are applied at the partner level.<sup>72</sup>

## **V. CONVERSION OF TYPE OF ENTITY AND DISREGARDED ENTITIES**

### **A. Overview**

Over the last decade, nearly all states have enacted statutes that allow business entities to convert from one type of entity to another type of entity by merely filing a form (such as articles of conversion) with the state (state law formless conversion statutes). Additionally, during this same time, many states have also enacted statutes allowing one type of business entity to merge into a different type of business entity, such as the merger of a corporation into an LLC (state law cross-entity merger statutes). The effect of such statutes is that title to the assets of the entities is automatically owned by the converted or surviving entity, and correspondingly liabilities automatically become liabilities of the converted or surviving entity.

Additionally, since the issuance of the “check-the-box” regulations in 1997, eligible entities have been able to select their classification for federal income tax purposes by simply “checking the box.”

These state law formless conversion statutes, cross-entity merger statutes and the check-the-box regulations can have significant non-tax and state tax law advantages, including:

1. the possible avoidance of non-transferability, acceleration, due on sale, and similar clauses contained in various contracts;
2. avoiding application of transfer fees, sales taxes, documentary stamp taxes, etc.; and
3. simplicity.

However, the ease of converting an entity from one type of entity to another type under state law formless conversion statutes, state law cross-entity merger statutes and the check-the-box regulations can present significant tax pitfalls and a trap for the unwary as a result of the federal tax consequences resulting from changing the tax classification of the entity for federal income tax purposes.

### **B. Change of a Sole Proprietorship or Disregarded Entity into an Association Taxable as a Corporation**

#### **1. In General**

One of the simplest types of changes in entity status is the incorporation of a sole proprietorship. This may be achieved by actual incorporation of a sole proprietorship, the filing of a Form 8832, Entity Classification Election, for a disregarded entity (such as a single-member LLC) to be treated as an association taxable as a corporation (or by simply filing a Form 2553,

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<sup>72</sup> See *Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999).

Election by a Small Business Corporation, which is treated as a deemed election for a single-member LLC to be taxed as an association), the conversion of a single-member LLC treated as a DE into a corporation under the applicable state law formless conversion statute, or the merger of a single-member LLC treated as a DE into a corporation under the applicable state law cross-entity merger statute. Whether achieved by actual incorporation of the sole proprietorship, filing an election under Section 8832 for a single-member LLC to be taxed as an association (or the filing of a Form 2553), the conversion of a single-member LLC into a corporation under the applicable state law formless conversion statute or the merger of a single-member LLC treated as a DE into a corporation under the applicable state law cross-entity merger statute, the tax consequences to the individual and the corporation should be the same.

## 2. General Incorporation Rules

(a) Recognition of Gain or Loss to Shareholder. Under the general rule of Section 351(a), no gain or loss is recognized if *property* is transferred to a corporation by one or more persons *solely in exchange for stock* in such corporation and *immediately after the exchange* such person or persons are in *control* of the corporation.

The general non-recognition rules of Section 351 will not apply if the new corporation constitutes an “investment company” under Section 351(e).

A corporation may be classified as an “investment company” if more than 80% of its assets are held for investment and constitutes stock, securities, money, etc.<sup>73</sup>

Even if the 80% test is met, the company will not be classified as an “investment company” unless it results in “diversification.” Diversification does not occur if each of the transferors conveys identical assets to the newly organized corporation. Additionally, diversification does not occur if not more than 25% of the portfolio of stock and securities conveyed by each transferor constitutes stock and securities of any one issuer, and not more than 50% of such portfolio is in the stock and/or securities of five or fewer issuers.<sup>74</sup>

(b) Receipt of Boot. If any cash or “other property” is received in connection with an incorporation, the transaction will not be disqualified from non-recognition treatment under Section 351(a), however, gain (the excess, if any, of the fair market value of the stock and other consideration received over the basis of the transferred assets) realized in the transaction will be recognized to the extent of any such cash or “other property” (i.e., “boot”) received. Specifically, Section 351(b) provides that if Section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under Section 351(a), other property or money, then gain to such recipient will be recognized but not in excess of the amount of money received, plus the fair market value of such other property received. Section 351(b)(2) provides that if a transferor receives boot, no loss may be recognized by the recipient.

Rev. Rul. 68-55,<sup>75</sup> provides that in determining gain recognized under Section 351(b)(1), where several assets are transferred, each asset must be considered transferred

<sup>73</sup> Sections 351(e)(1)(A) and (B), and Reg. §§ 1.351-1(c)(1)(ii), (iii) and (iv).

<sup>74</sup> Section 368(a)(2)(F)(i) and Reg. §§ 1.351-1(c)(1)(ii)(5), (6) and (7).

<sup>75</sup> 1968-1, C.B. 140.

separately in exchange for a portion of each category of consideration received. Each category of consideration received by the transferor is separately allocated to the transferred assets in proportion to their relative fair market values.

If a loss is realized with respect to any particular asset, it will not be recognized under Section 351(b)(2).

(c) Property Requirement. Section 351(d) provides that for purposes of Section 351, stock issued for: (1) services, (2) indebtedness of the transferee corporation which is not evidenced by a security; or (3) interest on indebtedness of the transferee corporation which is accrued on or after the beginning of the transferor's holding period for the debt, is *not* considered as issued in return for property. Under such circumstances, ordinary income could be realized to the extent that any stock received in the transaction is not attributable to the contribution of "property."

(d) Liabilities

(i) General Rules. Under the general rule of Section 357(a), if the taxpayer receives property which is permitted to be received under Section 351 without the recognition of gain if it were the sole consideration, and as part of the consideration, another party to the exchange assumes the liability of the taxpayer, then such assumption will *not* be treated as money or other property, and will *not* result in the recognition of gain except as provided below.

(ii) Liabilities in Excess of Basis. Under Section 357(c), to the extent that the aggregate amount of liabilities assumed by the corporation (or liabilities to which the assets received by the corporation in the transaction are subject) exceeds the adjusted basis of the assets transferred to the corporation, gain is recognized.

(iii) Tax Avoidance. Under Section 357(b), if, taking into consideration the nature of the liability and the circumstances in light of which the arrangement for the assumption was made, it appears that *the* principal purpose of the taxpayer with respect to the assumption of the liability was to avoid federal income tax on the exchange, *or* was not a bona fide business purpose, then such assumption (in the total amount of the liability assumed pursuant to the exchange) will, for purposes of Section 351, be considered as money received by the taxpayer on the exchange.

(e) Control. Another requirement that must be met for the nonrecognition rules of Section 351 to apply is that the transferors of the property to the corporation must be in "control" after the transaction. Section 368(c) defines the term "control" to mean the ownership of 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 of the corporation. An example of where this test would not be met is where even though the sole proprietor or individual owner of the disregarded entity receives the requisite ownership "immediately after the exchange," there is a plan to transfer stock to non-transferors as part of the same transaction. Three tests are primarily used to determine whether the transferors have control of the corporation "immediately after the exchange":

(i) Binding Commitment Test. The binding commitment test is



relatively straight forward. If, at the time the parties commence the first transaction, they are under a binding commitment to undertake the subsequent transactions, then all transactions will be integrated into one transaction.

(ii) Mutual Interdependence Test. This test has been articulated as being the question of whether “the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.”

(iii) End Results Test. Under the end results test, the IRS looks to whether the parties intended in the beginning to achieve a particular result, and whether the separate steps were merely entered into as a means of achieving that result.

(f) Basis for Stock. Under Section 358(a)(1), in the case of an exchange to which Section 351 applies, the basis of the stock received by the transferor is the same as the basis of the property exchanged: (a) decreased by the fair market value of any other property and money received by the taxpayer; (b) decreased by the amount of loss to the taxpayer which was recognized on the exchange; and (c) increased by the amount of gain to the taxpayer which was recognized on such exchange (a “substituted basis”).

(g) Holding Period for Stock. The holding period for the stock received in the exchange will receive “tacking” of the holding period of any assets transferred to the corporation, provided, however, ordinary income assets (assets other than a capital asset as defined in Section 1221 or property described in Section 1231) are not entitled to tacking and the holding period for the stock begins on the date following the date of the exchange.<sup>76</sup>

(h) Nonrecognition of Gain or Loss to Corporation. Under Section 1032(a), no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation.

(i) Basis of Property Contributed to Corporation. Under Section 362(a)(1), the basis of property contributed to a corporation in a transaction to which Section 351 applies is equal to the basis of the assets in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer (a “carryover” or “transferred” basis).

(j) Holding Period of Property Contributed to Corporation. Since the assets will have a “carryover” or “transferred” basis to the transferee corporation, Section 1223(2) allows the transferee corporation to tack on the transferor’s holding period for the contributed assets.

### 3. Tax Consequences to the Shareholder

(a) Recognition of Gain or Loss to Shareholder. Subject to the rules discussed above regarding the receipt of boot, the “property” requirement, liabilities in excess of basis and “nasty purpose” liabilities and the control requirement, under Section 351(a), no gain or loss is recognized to the shareholder if property is transferred to a corporation solely in exchange for

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<sup>76</sup> Section 1223(1).

stock in such corporation and immediately after the exchange such person is in control of the corporation.

(b) Basis of Stock to Shareholder. Under Section 358(a)(1), the shareholder will generally receive a “substituted basis” (i.e., a basis equal to his basis in the property transferred to the corporation) for his stock in the corporation, decreased by the fair market value of any other property or money received by the shareholder, decreased by the amount of loss to the shareholder recognized on the exchange and increased by the amount of any gain to the taxpayer which was recognized on the exchange.

(c) Holding Period of Stock. The shareholder’s holding period for the stock received will include shareholder’s holding period for any assets transferred to the corporation other than ordinary income assets.

#### 4. Tax Consequences to the Corporation

(a) Nonrecognition of Gain or Loss to Corporation. Under Section 1032(a), no gain or loss will be recognized by the corporation on the receipt of money or other property in exchange for stock of the corporation.

(b) Basis of Property Contributed to the Corporation. Under Section 362(a)(1), the corporation will generally receive a “carryover” or “transferred” basis in the assets the shareholder transferred to the corporation, increased by the amount of any gain recognized by the shareholder on the transfer.

(c) Holding Period of Property Contributed to Corporation. Under Section 1223(2), the corporation should be allowed to tack on the shareholder’s holding period for the contributed assets.

#### 5. Other Considerations

(a) Employer Identification Number. In the case of the incorporation of a sole proprietorship, a new employer identification number will need to be obtained for the corporation. In the case of an election by a disregarded entity such as a single-member LLC to be treated as an association taxable as a corporation, the conversion of a disregarded entity into a corporation under the applicable state law formless conversion statute, or the merger of a disregarded entity into a corporation under the applicable state law cross-entity merger statute, if the disregarded entity had an employer identification number prior to the transaction, then the corporation would use that number; otherwise, the corporation must obtain a new employer identification number.

#### (b) S Corporation

(i) Election of S Status. Regardless of whether the transaction involves the incorporation of a sole proprietorship, the election by a disregarded entity under the check-the-box regulations to be treated as an association taxable as a corporation, the conversion of a disregarded entity such as a single-member LLC under the applicable state law formless conversion statute, or the merger of a disregarded entity into a corporation under the applicable state law cross-entity merger statute, if the corporation desires to be taxed as an S corporation, an

S election will need to be filed for the corporation within two months and fifteen days of the incorporation, election to be treated as a corporation, conversion or merger, as the case may be.<sup>77</sup>

(ii) Deemed Election as Association by Filing Form 2553. An eligible entity that timely elects to be an S corporation under Section 1362(a)(1) is treated as having made an election to be classified as an association, provided that (as of the effective date of the election under Section 1362(a)(1)), the entity meets all other requirements to qualify as a small business corporation under Section 1361(b). Subject to Reg. § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election under Reg. § 301.7701-3(c)(1)(i) to be classified as other than an association.

6. From QSub to Association Taxable as a Corporation -Termination of QSub Election

The termination of a QSub election is effective: (a) on the effective date contained in the revocation statement if a QSub election is revoked; (b) at the close of the last day of the parent S corporation's last taxable year as an S corporation if the parent's S election terminates; or (c) at the close of the day on which an event occurs that renders the subsidiary ineligible for QSub status.<sup>78</sup>

In the event of a termination of the QSub's election, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination.<sup>79</sup> Without specifically providing that there is a deemed Section 351 transaction, Reg. §1.1361-5(b)(1) provides that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. The sale of 100% of the stock of a QSub is treated as the sale of the assets of the QSub followed by a Section 351 transfer of the assets to a new corporation by the purchaser (or purchasers).<sup>80</sup>

Prior to the 2007 Act, it was necessary to consider the control requirement (80% transferor group) in Section 368(c) for the termination of a QSub election, for example upon the sale of some or all of the shares, as well as assessing the potential impact of Section 357(c) and the other potential exceptions to tax free treatment. Under the 2007 Act, if a QSub election terminates because some or all of the QSub stock is sold, the sale is treated as a sale of an undivided interest in the assets of the QSub followed by a deemed Section 351 transfer of the assets to the new corporation by the purchaser (and the seller to the extent of any unsold shares).<sup>81</sup>

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<sup>77</sup> Sections 1362(a) and (b).

<sup>78</sup> See Reg. §1.1361-5(c).

<sup>79</sup> Section 1361(b)(3)(C).

<sup>80</sup> Reg. §1.1361-5(b)(1)(i), -5(b)(3)-Example 9.

<sup>81</sup> Section 1361(b)(3)(C)(ii), added by section 8234(a)(1)-(2) of the 2007 Act. This amendment to the Code makes Example 1 of Reg. §1.1361-5(b)(3) obsolete (providing that the sale of 21% of the stock of a QSub does not qualify under section 351 because immediately after the transfer, the selling S corporation is not in control of the QSub within the meaning of section 368(c)). The regulations have not been updated to reflect the statutory change.

If a QSub election terminates because the S corporation distributes its QSub stock to some or all of its shareholders in a transaction which qualifies under Section 368(a)(1)(D) and Section 355, then the Section 351 model will yield to the greater transaction (per step transaction). Reg. §1.1361-5(b)(2) provides that any loss or deduction disallowed under Section 1366(d) with respect to a shareholder of the parent S corporation immediately before the distribution will be allocated between the parent S corporation and the former QSub with respect to each shareholder. The amount allocated to the parent S corporation will bear the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the parent S corporation bears to the total value of the shareholder's stock in both the parent S corporation and the former QSub, determined immediately after the distribution.

A termination of QSub status may result through a revocation by the parent or a consequence of transferring a single share of subsidiary stock to a shareholder or third party. More specifically, Section 1361(b)(3)(c) provides that a upon termination, the QSub is treated as a new corporation acquiring all of its assets and assuming all of its liabilities from the S corporation parent in exchange for its stock. The former QSub is prohibited from re-electing S status or QSub status for 5 years unless permission is received from the Service.<sup>82</sup> The final regulations provide some relief. For S and QSub elections effective after 1996, where a QSub election terminates, the corporation may, without obtaining IRS consent, make an S election or be subject to a new QSub election prior to the end of the five year waiting period provided: (i) immediately following the termination, the corporation (or its successor) is otherwise eligible to make an S election or be subject to a QSub election, and (ii) the relevant election is made effective immediately following the termination of the QSub election.<sup>83</sup>

Example: Assume X, an S corporation, owns 100% of Y, a QSub and distributes all of its Y stock to X shareholders. The distribution terminates the corporation's QSub election.<sup>84</sup> Assuming Y is otherwise eligible to elect S, Y's shareholders may elect S status without IRS consent within the 5 year period. The same result applies were X to instead sell 100% of its Y stock to an unrelated S corporation, Z, where Z intends to make a QSub election effective on the date of the acquisition.

Rev. Rul. 2004-85<sup>85</sup> addresses whether a QSub election terminates when the QSub is transferred pursuant to a reorganization under Section 368. In a Section 368(a)(1)(F) transaction where an S corporation merges into a sister S corporation (having identical stock ownership), the QSub election for a QSub owned by the merging S corporation does not terminate. However, in transactions qualifying as reorganizations under Sections 368(a)(1)(A), (C) or (D), a QSub election for a subsidiary that is transferred as part of the transaction to an acquirer S corporation will terminate as of the date of transfer unless the acquirer S corporation makes a QSub election for the subsidiary effective immediately following the termination. If this new election is not made effective immediately following the termination, the subsidiary will not be eligible to be treated as

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<sup>82</sup> Section 1361(b)(3)(D). See Reg. §1.1361-5.

<sup>83</sup> Reg. §1.1361-5(c)(2).

<sup>84</sup> See also sections 368(a)(1)(D), 355, 311.

<sup>85</sup> 2004-33 I.R.B. 189.

a QSub or as an S corporation before the expiration of the waiting period under Section 1361(b)(3)(D).<sup>86</sup>

The final regulations provide that the effective date of a QSub termination is: (i) on the effective date contained in the revocation statement if a QSub election is revoked under Reg. §1.1361-3(b); (ii) at the close of the last day of the parent's last taxable year as an S corporation if the S election of the parent terminates under Reg. §1.1362-2; or (iii) at the close of the day on which a disqualification event occurs that results in the QSub not being described under Section 1361(b)(3)(B).<sup>87</sup>

Under the final regulations, where a tier of QSubs have their elections terminated on the same day, the formation of any higher tier subsidiary is deemed to have occurred prior to the formation of a lower tier subsidiary, a so-called "top to bottom" approach.<sup>88</sup>

#### 7. From QRS to Association Taxable as a Corporation; TRS Election

If a QRS ceases to meet the requirements to be a QRS, or upon an election to be treated as a taxable REIT subsidiary ("TRS"), the former QRS will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the REIT parent in exchange for stock.<sup>89</sup> The deemed transfer of assets to a new corporation will qualify for nonrecognition if the requirements of Section 351 are satisfied, similar to the termination of a QSub election.

### C. Changing a Corporation into a Sole Proprietorship or a Disregarded Entity (Single-Member Limited Liability Company)

#### 1. In General.

As opposed to an "incorporation" transaction such as the incorporation or conversion of a sole proprietorship or partnership into a corporation, the changing of a corporation or association taxed as a corporation into a sole proprietorship (or a partnership as will be discussed below), constitutes a "de-incorporation" transaction, which will *result in a taxable liquidation of the corporation*. One of the simplest types of de-incorporation transactions is the changing of a corporation into a sole proprietorship or single-member LLC treated as a disregarded entity for tax purposes.

As with the incorporation transactions discussed above, the change in entity status can be achieved by the actual liquidation of the corporation or the actual liquidation of an LLC which elected to be treated as an association taxable as a corporation, the conversion of a corporation into a single-member LLC (which does not elect to be treated as an association taxable as a corporation) under the applicable state law formless conversion statute, the merger of the existing corporation into a single-member LLC (which does not elect to be treated as an association taxable as a corporation) under the applicable state law merger statute, or for an eligible entity such as an LLC which has previously elected to be treated as an association taxable as a corporation, the filing

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<sup>86</sup> See also Rev. Proc. 2004-49, 2004-33 I.R.B. 210, for certain relief for late elections in this context.

<sup>87</sup> Reg. §§1.1361-5(a)(1),-5(a)(2)(information required to be filed upon failure to qualify as QSub).

<sup>88</sup> Reg. §1.1361-5(b)(1)(ii).

<sup>89</sup> Section 856(i)(3).

of a Form 8832, Entity Classification Election, to change the status of the entity from an association taxable as a corporation to a disregarded entity.

Whether achieved by a simple liquidation of the corporation to the sole shareholder who will operate the business as a sole proprietorship or form a new single-member LLC to operate the business, the conversion of a corporation into a single-member LLC under the applicable state law formless conversion statute for which an election is *not* made to treat the single-member LLC as an association taxable as a corporation, the merger of a corporation into a single-member LLC under the applicable state law merger statute where no election is made to treat the single-member LLC as an association taxable as a corporation, or the filing of a Form 8832 election for a change in classification of an eligible entity such as a single-member LLC which previously elected to be treated as an association taxable as a corporation to be treated as a disregarded entity, the tax consequences to the corporation and the shareholder should be the same.

## 2. Tax Consequences to the Corporation

(a) Recognition of Gain or Loss. Under the general rule of Section 336, the corporation will be treated as distributing all of its assets and liabilities to its sole shareholder in complete liquidation of the corporation. Specifically, Section 336(a) provides that the corporation will be treated as if its property were sold to the distributee at its fair market value.

(b) Treatment of C Corporation Versus S Corporation. Any gain or loss realized under Section 336 will be recognized at the corporate level if the corporation is taxed as a C corporation, but generally will not be subject to taxation at the corporate level if the corporation is an S corporation. Rather, such gain or loss will be passed through to the shareholders of the S corporation under Section 1366, and in turn increase their bases in the S corporation under Section 1367. However, if the S corporation is subject to the built-in gain tax imposed under Section 1374, the deemed sale of the property could trigger built-in gain tax at the corporate level.

(c) Beware of Section 1239. Because Section 336(a) provides that the property is treated as sold to the distributee at its fair market value, any gain attributable to depreciable property distributed to a shareholder owning more than 50% of the stock of the corporation may be subject to ordinary income, rather than capital/Section 1231 gain. Although this may not be important in the C corporation context since C corporations do not enjoy special capital gain rates, Section 1239 can have a significant impact on S corporations since the gain would flow through to the shareholders as ordinary income rather than as capital gain, and could cause a mismatching of ordinary income against capital loss. This poses a significant trap for the unwary.

(d) Deductibility of Loss on Liquidation. The corporation, whether a C or S corporation, will be allowed to deduct any losses on the deemed sale (to the extent the adjusted tax basis to the corporation of its assets exceeds the fair market value of such assets at the time of the distribution), with the following exceptions:

(i) Under Section 336(d)(1), no loss will be allowed on distributions to a more than 50% shareholder, unless the distribution is pro rata and the property was not acquired in a tax-free contribution transaction during the preceding 5-year period.

(ii) Under Section 336(d)(2), the IRS could disallow a loss on previously contributed property if “a” principal purpose of the contribution of that property was to recognize loss in connection with the liquidation.

### 3. Tax Consequences to the Shareholder

(a) Recognition of Gain or Loss. In addition to corporate-level gain or loss, under Section 331(a), the shareholder will recognize gain or loss to the extent the fair market value of the assets distributed to the shareholder exceeds such shareholder’s basis in the stock of the corporation or loss to the extent the shareholder’s adjusted tax basis in the stock of the corporation exceeds the fair market value of the property distributed to the shareholder. Any shareholder-level gain will constitute capital gain or loss if the shareholder has held his stock for more than one year.<sup>90</sup>

(b) C Corporation Versus S Corporation. Although both C corporation and S corporation shareholders will recognize gain or loss at the shareholder level, there should generally only be one level of tax in the event the corporation is an S corporation because any gain recognized at the corporate level under Section 336 will pass through to the shareholder under Section 1366(a) and increase such shareholder’s basis in his stock under Section 1367(a). Note, however, if ordinary income is triggered at the corporate level, by reason of gain from inventory, depreciation recapture or the application of Section 1239, as discussed above, any capital loss recognized at the shareholder level may not offset the ordinary income passed through to the shareholder under Section 1366. Under Section 1211(b), in the case of a taxpayer other than a corporation, losses from the sale or exchange of capital assets are allowed only to the extent of the taxpayer’s capital gains plus up to \$3,000 of ordinary income per year.

(c) Qualified Subchapter S Trusts. Another possible mismatching of gain and loss could occur in the case of the sale of S corporation stock by a qualified subchapter S trust (QSST), if the gain passing through from the S corporation is taxable to the current income beneficiary, whereas the loss on liquidation is taxable to the trust itself. However, the IRS has made it clear that both the loss and the corresponding gain in such situations should be reported by the QSST. See PLR 9721020 (Feb. 20, 1997), which provides that if an S corporation liquidates, the trust should report both (a) the Section 331 gain or loss on the stock; and (b) the Section 336 gain or loss that passes through from the corporation. See also PLR 201232003 (Aug. 10, 2012) and PLR 19992007.

### 4. From Corporation to QSub Status – the QSub Election

Once effective, the QSub election requires that the assets, liabilities, tax items, tax history, etc., of the QSub are treated as directly owned and realized by the S corporation parent for federal income tax purposes. All intercompany transactions presumably will be eliminated for federal tax purposes.<sup>91</sup> A similar rule is contained in Section 856(i), permitting a REIT’s ownership of a 100% subsidiary. As to the QSub, it would no longer add/subtract to its tax history, e.g., earnings and profits, AAA, etc., during the applicable period. There is a carryover of tax basis, which in turn

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<sup>90</sup> Section 1222.

<sup>91</sup> See S. Rept. No. 104-281, 104th Cong., 2d Sess. 54-55 (1996).

triggers application of Section 1374 with respect to transferred basis assets.<sup>92</sup> Where the subsidiary uses the LIFO method of inventory accounting, the making of the QSub election triggers the four year LIFO recapture rule. For state law purposes, the QSub is still recognized as a separate legal entity.<sup>93</sup>

Final regulations to the QSub rules were issued on January 25, 2000.<sup>94</sup> The final regulations generally apply to taxable years that begin on or after January 20, 2000; however, taxpayers previously could have elected to apply the regulations in whole, but not in part (aside from those sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided the corporation and all affected taxpayers apply the regulations in a consistent manner. To make the election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. The rules relating to the treatment of banks apply to all taxable years beginning after December 31, 1996.<sup>95</sup>

*Ownership of QSub Through Disregarded Entities.* A corporation may be a QSub even if all its stock is not actually owned by an S corporation, as long as all of its stock is treated as owned by an S corporation for federal income tax purposes. Therefore, an S corporation can make a QSub election for a subsidiary which it owns through other entities that are “disregarded” for federal income tax purposes.

*Debt, Options and Other Instrument and Arrangements Involving QSubs.* While the parent electing QSub must own all of the stock of the subsidiary, the question is whether there is any disguised equity floating around the QSub orbit through the issuance of debt, options or other arrangements held by third parties which would violate the QSub rules.<sup>96</sup> The Proposed Regulations did not provide any bright line rules or safe harbors. Instead, general federal tax principles are to be applied, including the safe harbors for options and straight debt instruments under Subchapter S. Instead, the amorphous set of 14 factors would be used to make this determination.<sup>97</sup>

In response to criticism of the rule applying general tax principles for determining if the parent owns all of the QSub stock, the final regulations adopt the position that arrangements that are not considered to be stock under the one class of stock rules set forth in Reg. §1.1361-1(l) will be disregarded. Commentators recommended that, for purposes of determining whether a subsidiary is wholly owned by the parent S corporation, arrangements that are not considered to be stock under the one-class-of-stock rules of Reg. §1.1361-1(l) should be disregarded. The final regulations provide a straight debt safe harbor if the obligation would meet the requirements under Reg. §1.1361-1(l)(5).<sup>98</sup> The commentators noted that applying the principles of these regulations would provide certainty with respect to the subsidiary’s eligibility to be a QSub and avoid difficult

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<sup>92</sup> Section 1374(d)(8).

<sup>93</sup> See IRS Notice 97-4. Reg. §1.1361-4.

<sup>94</sup> 65 FR 3843.

<sup>95</sup> Reg. §1.1361-4(a)(3)(iii).

<sup>96</sup> See Reg. §1.1361-1(l)(4)(ii)(B), (iii)(B), (iii)(C)(safe harbor rules for certain debt and option arrangements).

<sup>97</sup> See Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,” 26 Tax L. Rev. 369 (1971).

<sup>98</sup> Reg. §1.1361-2(b)(2), -2(c).



debt/equity determinations. Similar relief is provided for deemed exercise of an option under Reg. §1.1504-4.<sup>99</sup> An example of the use of straight debt to maintain QSub status is provided in Reg. §1.1361-2(d).

*Election of QSub Status.* Section 1361(b)(3) requires that an S corporation must file a QSub election for each applicable subsidiary otherwise the subsidiary will be treated as a C corporation. The election mechanics are set forth in Reg. §1.1361-3 which generally follows the rules set forth in the proposed regulations including the provision that a QSub election may be made by the S corporation parent at any time during the taxable year. The election form, which is still to be prescribed by the IRS, must be signed by the appropriate officer of the corporation under Section 6037. The election is filed with the Service center where the subsidiary filed its most recent tax return, or if a newly organized subsidiary, where the S corporation parent filed its most recent return.<sup>100</sup> The QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term “month” found in Reg. §1.1362-6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed. The final regulations further acknowledge that relief is available under the 9100 regulations for a late filing.<sup>101</sup>

An S corporation may revoke a QSub election under Section 1361 by filing the appropriate statement with the service center where the S corporation’s most recent tax return was properly filed. The revocation of a QSub election, provided the QSub election has not otherwise terminated for eligibility reasons, is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified.<sup>102</sup> The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

Reg. §1.1361-5 provides that an extension of time to make a QSub election may be available under the late election relief rule in Reg. § 301.9100 by filing a request with the National Office explaining the reason for the failure.<sup>103</sup> The final regulations acknowledge that 9100 relief is available for late QSub elections.<sup>104</sup>

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<sup>99</sup> See Reg. §1.361-4(a)(2)(v).

<sup>100</sup> Reg. §1.1361-3(a)(2).

<sup>101</sup> Reg. §1.1361-3(a)(6).

<sup>102</sup> Reg. §1.1361-2(b)(2).

<sup>103</sup> See PLRs 9834010, 9828025, 9827029 (granting late filed QSub elections).

<sup>104</sup> Reg. §1.1361-1(a)(6).

Rev. Proc. 98-55<sup>105</sup> contains relief provisions for late-filed QSub elections. The Revenue Procedure applies only to a corporation (i) for which a timely QSub election under Section 1361(b)(3)(B) was not filed for the desired effective date, (ii) for which a QSub election is filed within 12 months of the date that an election for the desired effective date should have been filed, and (iii) for which the due date for the S corporation's tax return (excluding extensions) for the first taxable year for which the S corporation desired QSub status for the subsidiary has not passed. The procedural requirements for this relief are as follows. Within 12 months of the due date for filing a QSub election to be effective on the desired effective date (but in no event later than the due date for the S corporation's tax return (excluding extensions)) for the first taxable year of the S corporation for which the S corporation intended to treat the subsidiary as a QSub, the corporation must file with the applicable service center a completed QSub election. The QSub election must state at the top the form "FILED PURSUANT TO REV. PROC. 98-55." Attached to the form must be a statement explaining the reason for the failure to file a QSub election within the time period required for the desired effective date.<sup>106</sup>

Rev. Proc. 2003-43,<sup>107</sup> in superseding the earlier Rev. Proc. 98-55, *supra*, provides for making a late QSub election within 2 years of its original due date by filing the form with the service center in the normal manner, but with a statement of reasonable cause attached. If the two-year period has passed, an S corporation may seek 9100 relief by filing a private letter ruling request with the National Office of the Service.<sup>108</sup>

As a result of the amendment to Section 1362(f) under the 2004 Act, relief is provided for defective QSub elections provided there are adequate grounds for establishing relief.

The 2005 Act provides that a QSub is a separate entity for purposes of making information returns, except to the extent otherwise provided by the Secretary. In other words, Treasury and the IRS have the authority to treat a QSub as a disregarded entity for purposes of information returns; the 2004 Act had mandated separate entity treatment for information return purposes.

The final regulations provide that a QSub election can be effective at any time during its tax year as long as the QSub eligibility requirements are satisfied at the time that the election is made and for all periods for which the election is to be effective.<sup>109</sup>

*Tax Treatment Of QSub Election.* Although the relevant statutory language does not specifically provide, the QSub election is treated as a deemed liquidation of a wholly owned subsidiary into its electing S corporation parent.<sup>110</sup> Under Section 337, no gain or loss is generally recognized by the liquidating subsidiary. Similarly, no gain or loss is recognized by the parent.<sup>111</sup> In accordance with Section 381, the S corporation parent will succeed to the QSub's entire tax history as well as the adjusted basis in its assets. Where the subsidiary has been a C corporation,

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<sup>105</sup> 1998-46 I.R.B. 27.

<sup>106</sup> See also Rev. Proc. 97-48, 1997-43 I.R.B. 19, 97-40, 1997-33 I.R.B. 50.

<sup>107</sup> 2003-1 C.B. 998.

<sup>108</sup> Reg. §1.1361-3(a)(6).

<sup>109</sup> Reg. §1.1361-3(a)(3); Reg. §§1.1361-3(a)(2), -3(a)(3).

<sup>110</sup> See Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted by the 100<sup>th</sup> Cong., *supra*.

<sup>111</sup> Section 332.

the liquidation will cause the parent S corporation to become subject to the built-in gains tax under Section 1374 with respect to the target's assets. If the target C corporation used the LIFO method of inventory accounting, the special recapture rule in Section 1363(d) comes into play. Post-QSub election problems may also be attributable to inheriting the target's C earnings and profits. Obviously, such will have an impact on characterizing post-QSub election distributions by a parent S corporation to its shareholders.<sup>112</sup> Where there is a significant amount of passive investment income, the carryover of the target's earnings and profits may result in an entity level tax under Section 1375 and/or eventually pose a termination risk under Section 1362(d)(3).

Although Section 1361(b)(3) allows the Service to issue regulations to make exceptions to the general rule disregarding a QSub's separate status for federal tax purposes, the proposed regulations provided only one exception for banks described in section 581. Final Reg. §1.1361-4(a)(3)(i) provides that for any QSub that is a bank, all of its assets, liabilities and items of income, deduction and credit, determined in accordance with the special bank rules, are treated as being the assets, liabilities, etc., of the S corporation parent.

Debt instruments issued by a QSub to a shareholder of the S corporation-parent are also treated as debts of the parent under Section 1366(d)(1)(B). This rule permits the flow through of losses up the S tier to the ultimate shareholder. However, it would appear that the at-risk rules apply at the shareholder level and require a determination of the extent to which each shareholder is "at-risk" with respect to the QSub's operations. There will also be instances where shareholders of the parent hold debt of both the parent S corporation and the QSub. The legislative history indicates that the Treasury may issue regulations regarding the order that the losses pass through.

For states which have "piggyback" statutes which borrow from federal definitions of Subchapter S, it would appear that the QSub rules will be respected for state income tax purposes. Uncertainty is present however for those states which have separate definitions or modifiers, or, for states which do not recognize or otherwise tax S corporations,

Section 332(b) requires that the parent must adopt a plan of liquidation when it owns 80% or more of the stock of the liquidating subsidiary. A QSub election is, by design, a constructive liquidation. Since the subsidiary will not liquidate under state law, the question arises as to whether the adoption of a plan of liquidation is necessary. The timing of the deemed liquidation may also affect its tax consequences. The deemed liquidation is effective at the close of the date prior to the QSub election becoming effective.<sup>113</sup> For the conversion of a consolidated group (and its parent corporation), the S corporation/QSub election deemed liquidation of the QSubs will be deemed to occur in the last consolidated return year. This means that ELA will be eliminated.<sup>114</sup>

Generally, the ordering of the QSub elections is from the "bottom up" in order to avoid ELA recapture unless the election form designates a QSub election sequence.<sup>115</sup> However, an election may be made to change the ordering of the QSub election from top to bottom. For example, if A, an S corporation, owns all of the stock of B and C, and B and C each own 50% of

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<sup>112</sup> Section 1368(c).

<sup>113</sup> Reg. §1.1361-4(b)(1).

<sup>114</sup> Reg. §1.1502-19(b)(2)(i).

<sup>115</sup> Reg. §1.1361-4(b)(2).

the stock of D, A should specify that the B and C liquidations occur first, in order to qualify the entire set of deemed liquidations.<sup>116</sup>

Where the QSub election is made after the acquisition of another corporation, the liquidation is deemed to occur immediately after the stock ownership requirement is met.<sup>117</sup>

The deemed liquidation occurs immediately after the deemed asset purchase.<sup>118</sup> The regulations provide that, for purposes of satisfying the requirement of Section 332(b) that the parent corporation own stock in the subsidiary meeting the requirements of Section 1504(a)(2) on the date of adoption of the plan of liquidation of the subsidiary, the plan of liquidation is deemed adopted immediately before the deemed liquidation incident to a QSub election unless a formal plan of liquidation that contemplates the filing of the QSub election is adopted on an earlier date.<sup>119</sup> Still if as a result of the application of general tax principles the transactions that include the QSub election are treated as an asset acquisition, and as further subject to transitional relief, Section 332 is not applicable and this rule has no relevance.

*Application of Step Transaction Doctrine.* Applying step transaction to the acquisition of stock that precedes a QSub election can cause the transaction to be recast as an asset acquisition under Section 368 with unfortunate results for the unwary or unsophisticated, which again, is inconsistent with the legislative history to QSub.<sup>120</sup>

The final regulations provide that general principles of tax law, including the step transaction doctrine, will apply to determine the tax consequences of the transactions that include a QSub election. The final regulations provide examples illustrating the results of applying step transaction in the context of a QSub election.

In *Bausch & Lomb Optical Co. v. Commissioner*,<sup>121</sup> the taxpayer owned 79 percent of the stock of a subsidiary corporation. In order to acquire its assets, the taxpayer issued its stock in exchange for all the assets; the subsidiary then liquidated, distributing the parent's stock pro rata to all of its shareholders. The outside shareholders of the subsidiary thus became minority shareholders of the parent. The various steps were held to constitute a single plan having the effect of a taxable liquidation (to the extent of the assets received in exchange for the parent's 79 percent stock interest), rather than a tax-free Type C reorganization, on the theory that the assets were acquired by the taxpayer in consideration for its stock of the subsidiary rather than in exchange for its own voting stock, as required by Section 368(a)(1)(C).

Similarly, where an S corporation forms a subsidiary and makes a valid QSub election for the subsidiary effective as of the date of the formation of the subsidiary, no deemed liquidation

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<sup>116</sup> See Form 8869.

<sup>117</sup> Reg. §1.1361-4(b)(3)(i).

<sup>118</sup> Reg. §1.1361-4(b) and (d), Example 3.

<sup>119</sup> Reg. §1.1361-4(a)(2)(iii), (iv).

<sup>120</sup> See generally, Rev. Rul. 67-274 (1967-2 C.B. 141) (which treats as a Type C reorganization an acquisition of the stock of one corporation by another corporation, solely in exchange for voting stock of the acquiring corporation, followed by a liquidation of the target corporation pursuant to a plan). For a defense of the Service's application of the step transaction doctrine to the deemed liquidation resulting from the making of a QSub election see Anderson, "Reexamining the Qualified Subchapter S Subsidiary—Years Later," 40 Tax Mgt. Mem., No. 24 (Nov. 22, 1999).

<sup>121</sup> 267 F.2d 75 (2d Cir. 1959) cert denied 361 U.S. 835 (1959).

should be treated as having occurred since the subsidiary will never have been a separate corporation.

Example: X is an S corporation which operates retail and manufacturing divisions. In January, 2005, X contributes the retail operations, subject to liabilities, which liabilities exceed the adjusted basis of the retail assets, to a newly formed corporation Y in exchange for all of Y's stock and makes a QSub election effective as of the date of formation of Y. If Section 332 applied, the liquidation would be taxable since Y is insolvent. Similarly, Section 357(c) should not apply since there is no Section 351 transaction. Reg. §1.1361-1(a)(2) applies step transaction analysis to ignore the deemed liquidation under Sections 337 and 332 and treat the transaction simply as the formation of a newly organized subsidiary.

Another example of the application of the step transaction doctrine in the context of a QSub election is a qualified stock purchase followed by a QSub election.<sup>122</sup> In the first example of the Regulations, a C corporation acquires all of a solvent, target corporation from an unrelated individual for cash and short-term notes. As part of the same plan, the acquiring corporation immediately makes an S election for itself and a QSub election for the target. The example provides that since the stock purchase is "qualified" per Section 338(d)(3), the deemed liquidation is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under Sections 332 and 337.<sup>123</sup> Other examples are discussed under Disregarded Entities in Corporate Reorganizations.

*Timing of Deemed Liquidation.* Under Reg. §1.1361-4(b), rules are set forth for the date on which the deemed liquidation resulting from a QSub election occurs. Where the S corporation parent owns all of the subsidiary stock prior to the effective date of the QSub election, the proposed regulations provide that the deemed liquidation occurs at the close of the day prior to the effective date of the QSub election. This was the same rule previously contained in the proposed regulations. Thus, if a C corporation elects to be treated as an S corporation and makes a QSub election effective on the same date, the liquidation occurs immediately prior to the S election becomes effective, while the S electing parent is still a C corporation. This timing rule has significant implications for consolidated groups which convert to S corporation and QSub status.

A second rule pertains to acquisitions of target corporations, i.e., where an S corporation does not own all of the subsidiary's stock on the day before the QSub election is to be effective. In this situation, the regulations provide that the deemed liquidation occurs immediately after the time at which the S corporation's owns 100% of the subsidiary's stock.<sup>124</sup>

The QSub election is not effective for the target until the day after the acquisition date. The deemed liquidation resulting from the QSub election occurs immediately after the date of the deemed asset purchase by the new target corporation under Section 338.<sup>125</sup> Where the S corporation makes an election under Section 338 (without a Section 338(h)(10) election) with

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<sup>122</sup> Reg. §1.1362-4(a)(2)(ii).

<sup>123</sup> See Rev. Rul. 90-95; Reg. §1.338.

<sup>124</sup> Reg. §1.1361-4(b)(2).

<sup>125</sup> Section 338(h)(2). Reg. §1.1361-4(b)(2).

respect to a target, the target must file a final or deemed sale return as a C corporation for the deemed sale.<sup>126</sup>

*Effect of QSub Election on S Corporation's Basis in Subsidiary Stock.* Aside from the tax history issues generated by a deemed liquidation, perhaps the most immediate drawback to the QSub is the disappearing basis problem. Suppose, for example, that an S corporation purchases all of the stock of a target C corporation (in a non-Section 338 transaction) at a purchase price of \$2,000x. Assume the target's basis in its assets is \$500x. By purchasing all of the target's stock and making the QSub election (or, alternatively, by immediately liquidating the target into the purchaser), the parent's cost basis in the subsidiary stock, i.e., \$2,000x, disappears. The only relevant basis to the parent is the adjusted basis of the subsidiary's assets. The \$2,000x basis is not reinstated if there is a termination of the QSub election because the subsidiary is treated as a newly-formed corporation at that time under Section 1361(b)(3)(C). Again, the inside versus outside value differential will present built-in gains tax problems to the purchaser with respect to the QSub's assets. The total net unrealized built-in gain is allocated on an asset-by-asset basis including goodwill and going concern value.<sup>127</sup>

*Acquisitions of S Corporations—AAA and Suspended Losses.* The Regulations acknowledge that the AAA of a target S corporation which is acquired in a tax-free reorganization or liquidation described in Sections 337/332 will be inherited by the acquiring corporation.<sup>128</sup> Reg. §1.1361-4(c) further provides that suspended losses also carry over where one S corporation acquires the stock of another S corporation referencing Reg. §1.1366-2(c)(1).

*Application of Built-In Gains Tax to QSub Elections.* Section 1374 imposes a corporate level tax on the built in gains of an S corporation after it has converted from C corporation status. The tax is imposed on net recognized built-in gains for the subsequent 5-year period following the effective date of a C to S conversion. Section 1374(d)(8) provides the Section 1374 tax carries over with respect to an S corporation's receipt of transferred basis property from another C corporation or S corporation having an unexpired recognition period under Section 1374 from a prior conversion event. Therefore, Section 1374(d)(8) will apply with respect to the purchase of all of the stock of a target corporation and subsequent QSub election under the deemed liquidation rule. In such case, a separate determination of tax is made with respect to the assets acquired by each particular target corporation. Regulations under Section 1374 provide that the tax attributes of the target, e.g., net operating loss and capital loss carryovers, may only be used against the target's subsequent recognized built-in gains.<sup>129</sup> Furthermore, Section 1374 attributes acquired in one Section 1374(d)(8) transaction may only be used to reduce the tax on the disposition of assets acquired in that transaction. This results in a "Libson Shops" type separate pooling approach.

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<sup>126</sup> Reg. §1.338-10T(a). Reg. §1.1361-4(d), Ex. 3.

<sup>127</sup> Sections 334(b)(1), 1374(d)(8), 1374(d)(1). Treas. Regs. §§1.334-1(b), 1.1361-4(a)(4)(except for purposes of Section 1361(b)(3)(B)(i) and Reg. §1.1361-2(a)(1), the stock of a QSub is disregarded for federal tax purposes).

<sup>128</sup> Reg. §1.1368-2(d)(2).

<sup>129</sup> Reg. §1.1374-8(b).

**D. Conversions of a Disregarded Entity into a Partnership and a Partnership into a Disregarded Entity**

**1. In General**

The acquisition of a disregarded entity by a single buyer is treated for federal income tax purposes as the sale of assets by the owner of the disregarded entity which neither elected or converted to association status. The check-the-box regulations do not address a change in tax status caused by a change in number of members, but this subject has been addressed by the IRS in two well-known rulings.<sup>130</sup>

**2. Conversion of a Disregarded Entity into a Partnership: Increase From One Member to Two (or More) Members**

In Rev. Rul. 99-5, *supra*, two scenarios involving the conversion of a disregarded entity into a partnership are discussed. In both cases, A owns 100% of the interests in an LLC valued at \$10,000 and B purchases a 50% interest from A.

(a) In situation one, B acquires the interest from A for \$5,000. The transaction is treated as a sale of one-half of each asset to B, followed by a contribution of all of the assets by A and B to a new partnership. A recognizes gain or loss on the sale of each asset held by the LLC.

(b) In situation two, B acquires a new 50% interest in the LLC from the LLC for \$10,000 and the proceeds of the sale are retained in the business of the LLC. The transaction is treated as a transfer of all of the assets by A to a new partnership for an interest in the partnership, and a transfer of cash by B to the new partnership. No gain or loss, in general, is recognized by either party under Section 721.

(c) What if A transfers an interest in the LLC to B, but A contributes the cash to the business, so that their interests were 2/3 to A and 1/3 to B? Would the form of the transaction be followed, resulting in gain to A on an asset sale to B, or would the transaction be treated as a subscription by B to a 1/3 interest in the resulting partnership, resulting in nontaxable Section 721 treatment to A?<sup>131</sup>

(d) What if B purchases his interest directly from the LLC but cash is distributed to A? Presumably the disguised sales rules under Section 707(a)(2)(B) would apply. This result could also occur if A caused new liabilities to be assumed by the new entity.

(e) Other Consequences. Each scenario will have a varying outcome with respect to: (i) basis; (ii) holding period; (iii) Section 704(c) attributes and possibly with respect to Section 197.

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<sup>130</sup> Rev. Rul. 99-5, 1999-1 C.B. 434 (increase in number of owners of disregarded entity from one to two or more), and Rev. Rul. 99-6, 1999-1 C.B. 432 (sale of membership interest in a partnership to a single purchaser resulting in the conversion to a disregarded entity).

<sup>131</sup> See Monte A. Jackel, "New Rulings Address One-to-Two and Two-to-One Entity Conversions", 82 Tax Notes 1167 (Feb. 22, 1999).

### 3. Conversion of a Partnership into A Disregarded Entity: Purchase of All of the Interests in an LLC Taxable as a Partnership by One Buyer

In Rev. Rul. 99-6, the IRS addressed the purchase of all of the interests in an LLC taxed as a partnership by a single purchaser, resulting in a conversion to an single-member LLC.

(a) In situation one, A and B are each equal 50% owners of an LLC. B purchases A's interest in the LLC for 10X and continues to operate the business as a single-member LLC. The ruling concludes that: (i) the partnership terminates under Section 708(b)(1)(A); (ii) A, under Section 741, is treated as selling his partnership interest to B; and (iii) B, however, is treated as if the LLC first made a liquidating distribution of all of its assets to A and B and then B acquired the assets deemed distributed to A for full monetary consideration paid. B would therefore have a carryover basis in 1/2 of the assets (his pre-purchase share and tacking of holding period for his interest) and a fair market value purchase price basis in 1/2 of the assets deemed purchased from A with a new holding period.

(b) In situation two, C and D are equal partners in CD, an LLC. C and D sell their entire interests in CD to E, an unrelated person, for \$10X each. The business is continued by the LLC, which is owned solely by E. The IRS concluded: (i) the CD partnership terminates under Section 708(b)(1)(A); (ii) C and D must report gain or loss under Section 741; (iii) the CD partnership is deemed to make a liquidating distribution of its assets to C and D; and (iv) immediately thereafter, E is deemed to acquire, by purchase, all of the former partnership's assets. E has a cost basis of \$20X in the assets and a new holding period. Compare Rev. Rul. 84-111,<sup>132</sup> which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with *McCauslen v. Comm'r*,<sup>133</sup> and holds that the transferee's basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with Section 732(c).

### 4. AICPA Proposes that Rev. Rul. 99-6 be Revoked or Clarified

In a letter dated October 1, 2013, the American Institute of CPAs (AICPA) provided comments on Rev. Rul. 99-6 relating to the conversion of partnerships to disregarded entities. In the letter, the AICPA proposes that Rev. Rul. 99-6 be revoked, and that a sale which results in a partnership being converted into a disregarded entity be treated as the sale of a partnership interest by the selling partner or partners, and likewise that the purchaser be treated as acquiring the seller's partnership interest followed by a liquidating distribution of all of the assets of the partnership to the purchaser.

## **VI. USE OF DISREGARDED ENTITIES IN TAX PLANNING**

### **A. Disregarded Entities in Corporate Reorganizations**

#### 1. Proposed and Final Regulations on Mergers Involving Disregarded Entities

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<sup>132</sup> 1984-2 C.B. 88 (Situation 3).

<sup>133</sup> 45 TC 588 (1966).



On May 17, 2000, the Service issued a proposed rulemaking<sup>134</sup> on mergers involving disregarded entities. The proposed regulations revised paragraph (b)(1) of Reg. §1.368-2(b)(1) and adopted the view that a merger involving a corporation and a disregarded entity is not a statutory merger for purposes of qualifying as a tax-free reorganization under Section 368(a)(1)(A).<sup>135</sup> The proposed regulations would have extended to a qualified subchapter S subsidiary or QSub, a limited liability company (LLC) with a single corporate owner which does not elect to be treated as a separate corporation, or a qualified REIT subsidiary. Section 368(a)(1)(A), discussed below, requires that a qualifying reorganization constitute a “statutory merger or consolidation.”<sup>136</sup> Under the Proposed Regulations, the merger of a disregarded entity (“DRE”) (including a QSub or qualified REIT subsidiary) into a tax corporation would not be a Type A reorganization because the merging entity is not a tax corporation. In Rev. Rul. 2000-5, the Service held that a Type A merger must involve the transfer of the assets of a target corporation to a single transferee corporation ceasing to exist as a result of the “merger” Rev. Rul. 2000-5 implies that a merger of a DRE (single member) owned by a corporation (including a QSub), cannot be a Type A reorganization because it will be divisive and will not necessarily result in the termination or liquidation of the member. Due to the additional requirements for a Type C (“substantially all of the transferor’s assets,” no more than 20% boot, including liability assumptions, and “solely for voting stock” requirements) and Type D (“substantially all”/liabilities in excess of basis) reorganization, many of the DRE mergers would constitute taxable transactions under the 2000 proposed regulations.<sup>137</sup>

The final regulations, issued in 2003, retain much of the conceptual background to the proposed regulations, including the definition of a disregarded entity.<sup>138</sup> Examples are set forth in the regulations which apply to disregarded entities, such as a domestic, single member LLC which does not elect to be treated as a corporation for federal income tax purposes, a qualified REIT subsidiary per Section 856(i)(2) and a QSub per Section 1361(b)(3)(B).<sup>139</sup> Defined terms included the following:

- (i) Disregarded Entity; a business entity that is disregarded as an entity separate from its owner for Federal tax purposes;
- (ii) Combining Entity; a business entity that is a corporation that is not a disregarded entity;
- (iii) Combining Unit; is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such entity for Federal tax purposes;

<sup>134</sup> REG-106186-98, 65 FR 31115-01.

<sup>135</sup> See also Rev. Rul. 2000-5, 2000-5 IRB 1.

<sup>136</sup> Reg. §1.368-2(b)(1) provides that a statutory merger or consolidation must be effectuated in accordance with the “corporation laws” of the United States or a state, territory, or the District of Columbia.

<sup>137</sup> See Rev. Rul. 70-107, 1970-1 C.B. 78 (assumption of target liabilities by wrong corporation in an attempted triangular acquisition resulted in invalid Type C reorganization treatment).

<sup>138</sup> Reg. §301.7701-2(b)(5).

<sup>139</sup> These proposals were adopted as Temporary Reg. §1.368-2T(b)(1) by TD 9038 on Jan. 24, 2003; and became final in TD 9242 (Jan. 23, 2006).

- (iv) Transferor Unit; and
- (v) Transferee Unit.<sup>140</sup>

With an A reorganization involving a disregarded entity, i.e., a statutory merger or consolidation effected pursuant to the statute or statutes necessary to effect the merger or consolidation, the following events occur simultaneously at the effective time of the transaction; (i) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (ii) the combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of Reg. §1.368-2(b)(1)-(ii)(A).

The final regulations can be viewed as consistent with rulings previously issued by the Service. In Situation 1 of Rev. Rul. 2001-46,<sup>141</sup> an acquirer purchased a target corporation by means of two consecutive mergers. First, all of the target's outstanding stock was acquired in a reverse triangular merger (the "Acquisition Merger"), in which the merger consideration consisted of 30% cash and 70% stock. Next, the target, a wholly owned subsidiary of the acquirer, was merged upstream into the acquirer (the "Upstream Merger"). The Service held that the two steps should be integrated and treated as an asset acquisition under Rev. Rul. 67-274. Because Section 338 policies do not dictate otherwise, this transaction is treated as an A reorganization.<sup>142</sup>

In Situation 2 of the Ruling, the facts are the same as in Situation 1 except that in the Acquisition Merger the target shareholders receive solely voting stock in the acquirer in exchange for their target stock, so that the Acquisition Merger, if viewed independently of the Upstream Merger, would qualify as a reorganization under 368(a)(1)(A). The Service held that the difference in consideration (all stock, no cash) does not change the result in Situation 1.

Because Section 368(a)(1)(A) does not contain a 20% boot limitation (or a "substantially all" requirement), Rev. Rul. 2001-46 sanctions the use of a second step upstream merger to avoid the limitations of a reverse triangular merger under Section 368(a)(2)(E). The same consequences would apply if the target was converted or merged into a disregarded entity owned 100% by the acquirer, treated as an A reorganization under the final regulations dealing with mergers involving disregarded entities.

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<sup>140</sup> Reg. §1.368-2(b)(1)(i)(C).

<sup>141</sup> 2001-42 I.R.B. 1 (September 25, 2001).

<sup>142</sup> See *King Enterprises, Inc. v. U.S.*, 418 F.2d 511 (CT. CL. 1969); Rev. Rul. 67-274.

## 2. Reorganizations Involving QSubs

QSubs can be part of a tax-free reorganization, such as a Section 368(a)(1)(A) merger or consolidation.<sup>143</sup> Provision is made that if a target S corporation that has a QSub merges into a disregarded entity, the termination of the QSub election followed by the deemed contribution of the former QSub's assets to a new C corporation immediately prior to the merger does not disqualify the merger under Section 368(a)(1)(A).<sup>144</sup> These regulations generally apply to transactions occurring on or after January 23, 2006.<sup>145</sup>

As discussed further above, the Service and Treasury proposed regulations in January 2005 containing a revised definition of statutory merger or consolidation that allows transactions effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation. Simultaneously with the publication of the 2005 proposed regulations, the IRS and Treasury Department published a notice of proposed rulemaking proposing amendments to the regulations under Sections 358, 367, and 884 to reflect that, under the 2005 proposed regulations, a transaction involving a foreign entity and a transaction effected pursuant to the laws of a foreign jurisdiction may qualify as a statutory merger or consolidation (the foreign regulations). The regulations were finalized in January, 2006.<sup>146</sup>

*Acquisition of Stock Through Type C Reorganization Followed by QSub Election for Target Corporation.* In this example, target corporation is acquired by acquiring corporation solely for voting stock of acquiring corporation as part of a transaction intended to meet the requirements under Section 368(a)(1)(C). Immediately upon making the acquisition, acquiring corporation makes an S election and files a QSub election for target. The example concludes that the transaction will be a type C reorganization, assuming that the other conditions for reorganization treatment are satisfied.

*Deemed Liquidation Recharacterized as Type D Reorganization.* Another example in the final regulations raises the potential problem under Section 357(c) in connection with a QSub election. Of course, this problem was removed temporarily under a transactions rule contained in Reg. §1.1361-4(a)(5)(i) and was removed permanently by the 2004 Act which amended Section 357(c) so that it is only applicable to *divisive* D reorganizations involving Section 355. Prior to the 2004 amendment to Section 357(c), assume Individual A contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The example concludes that the transaction will be a Type D reorganization, assuming the other conditions for reorganization treatment are satisfied, and consequently, that if the sum of the Y liabilities treated as assumed by X exceeds the total of the adjusted basis of Y's

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<sup>143</sup> Reg. §1.368-2(b)(iv) ex. 2.

<sup>144</sup> See Reg. §1.368-2(b)(1)(iii) Ex. 3 (providing that the deemed formation by the target S corporation of a C corporation subsidiary as a result of the termination of its subsidiary's QSub status is disregarded for federal income tax purposes; the target S corporation is viewed as transferring the assets of its subsidiary to the acquirer followed by the acquirer contributing those assets to a new C corporation subsidiary in exchange for stock); see also Reg. §1.1361-5(b)(3) Ex. 9.

<sup>145</sup> Reg. §1.368-2(b)(1)(v).

<sup>146</sup> 71 FR 4259-01, 2006-7 I.R.B. 422, 2006 WL 173491 (F.R.).

property, Section 357(c) will apply to the transaction and the excess will be gain from the sale of the contributed assets as allocated under relative FMVs.<sup>147</sup>

*QSub Election Involving Insolvent Subsidiary.* Despite receiving comments that insolvent subsidiaries should qualify for a tax free liquidation, the final regulations treat insolvent subsidiary liquidations, even as part of a QSub election, as outside of Section 332. In general, Section 332 does not apply to the liquidation of an insolvent corporation, because the parent corporation does not receive at least partial payment for the stock of its subsidiary. An example is provided in the final regulations.<sup>148</sup> In such instance the tax attributes and adjusted basis of the assets of the subsidiary will not carry over to the parent. As far as transitional relief is concerned, the final regulations provide that for related party acquisitions followed by a QSub election, the step transaction will not apply provided the QSub election is made prior to January 1, 2001.<sup>149</sup> Examples are provided in the regulations as to the application of transitional relief.

*"F" Reorganizations.* While the step transaction was adopted in the proposed and final regulations to the QSub rules, some argued that during the transition period where the step transaction is not applicable, per se, the formation of a new shell S corporation (Newco) by the shareholders of an existing S corporation in a mid-year formation, qualify as a Type F reorganization if all of the other requirements of the Section are met. As a Type F reorganization, the taxable year of the existing S corporation does not close. The preamble to the final regulations provides that during the extended transition period set forth in the final regulations, the Service will not challenge taxpayers who, through use of the step transaction doctrine to an acquisition of stock followed by a QSub election, employ the tax treatment applicable to a Type F reorganization.

In Ltr. Rul. 201007043, the IRS ruled that an S corporation's merger into its wholly owned QSub constituted a tax-free reorganization under Section 368(a)(1)(F) without adversely affecting S corporation status. In the ruling, the S corporation and one of its two wholly owned QSubs desired to combine their assets and operations into a single corporation in order to take advantage of planned efficiencies and to reduce expenses and redundancies. Because certain legal agreements of the QSub prohibited the QSub from merging upstream into the S corporation, it was decided that the S corporation should merge downstream into the QSub.

Citing Rev. Rul. 64-250,<sup>150</sup> the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSub following the merger. Additionally, citing Rev. Rul. 2004-85,<sup>151</sup> the IRS found that the status of the S corporation's other QSub would not terminate as a result of the F reorganization.

Interestingly, the ruling does not address whether the surviving entity should continue to use the federal identification number previously used by the S corporation or the federal identification number of the QSub into which it was merged. In Rev. Rul. 73-526,<sup>152</sup> the IRS ruled that where an S corporation merges into another corporation in a transaction qualifying as an F

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<sup>147</sup> This example has not been updated to reflect the 2004 amendment to Section 357(c).

<sup>148</sup> Reg. §1.332-4(d), Ex. 5.

<sup>149</sup> Reg. §1.1361-4(a)(5)(i).

<sup>150</sup> 1964-2 CB 333.

<sup>151</sup> 2004-2 CB 189.

<sup>152</sup> 1973-2 CB 404.

reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation. However, more recently in Rev. Rul. 2008-18,<sup>153</sup> the IRS ruled that in the two situations presented in the ruling, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the newly formed corporations would be required to obtain new employer identification numbers and that the existing corporation which became a QSub would retain its same employer identification number.

## **B. Like-Kind Exchanges Using Disregarded Entities**

Section 1031(a) provides that no gain or loss is recognized on the disposition of property (“relinquished property”) which was held for productive use in a trade or business or for investment if the relinquished property is exchanged solely for like kind property (“replacement property”) which is to be held either for productive use in a trade or business or for investment. Section 1031(a)(2) provides that stocks and partnership interests do not qualify for like kind exchange treatment.

With the availability of disregarded entities, taxpayers can structure like kind exchanges with disregarded entities as special purpose holding companies.

Example. Taxpayer A has transferred some real estate and wishes to structure a like-kind exchange. A would like to acquire all of the interests in Swap LLC, an entity that owns like-kind property. Swap LLC is wholly-owned by B. The acquisition of all of the interests in Swap LLC by A would be treated as an acquisition of the like-kind property owned by Swap LLC. From B’s perspective, the transaction would be treated as a sale of the Swap LLC assets.

Example. Assume the same facts as in the previous Example, except that Swap LLC is owned by B, C and D. The moment before A acquires all of the LLC interests, Swap LLC was an entity treated as a partnership for tax purposes. Immediately after the transaction, Swap LLC is a disregarded entity. Partnership interests are not good like-kind exchange property.<sup>154</sup> However, the transaction is treated as a sale of partnership interests by B, C and D, but it is treated as a purchase of assets by A.<sup>155</sup> Consequently, the transaction is a good like-kind exchange for A. Of course, if A only acquired the interests owned by B and C. but not D, A would not have a good like-kind exchange because Swap LLC would not be a disregarded entity immediately after the purchase.

Example. Assume that A held his relinquished real estate in a single member LLC. A transferred all of the interests in LLC to B, C and D. The transaction is treated as a transfer of assets by A to B, C and D.<sup>156</sup> B, C and D are treated as contributing their fictional undivided interests in the assets to the LLC immediately thereafter. Thus, A would be entitled to structure a like-kind exchange. Note that if B, C or D were attempting to use the purchase as replacement

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<sup>153</sup> 2008-1 CB 674.

<sup>154</sup> Section 1031(a)(2)(D).

<sup>155</sup> Rev. Rul. 99-6, 1999-1 C.B. 432.

<sup>156</sup> Rev. Rul. 99-5, 1999-1 C.B. 434.

property in their exchanges, they would have to contend with the “holding” requirement of Section 1031.<sup>157</sup>

Suppose that A transferred only a portion of his interest in his single member LLC. Rev. Rul. 99-5<sup>158</sup> would still treat A as having transferred an undivided interest in the real estate owned by the single member LLC. Thus, A would still be entitled to 1031 treatment (assuming all requirements of Section 1031 are otherwise satisfied) because he did not sell a partnership interest.

Example. S Corp’s only asset is 100% of the stock of QSub, a qualified S subsidiary. QSub owns investment real estate. Stock is not good like-kind exchange property.<sup>159</sup> The sale of all of the QSub stock will be treated as if S Corp sold, and the purchaser bought, all of the assets of QSub.<sup>160</sup> The purchaser is then deemed to have contributed the assets to QSub in exchange for QSub stock. S Corp may close the like-kind exchange by buying all of the stock of an unrelated QSub that owns investment real estate if the QSub remains a QSub in the hands of S Corp. However, a transfer of less than all of the stock would not qualify for like kind treatment.<sup>161</sup>

Alternatively, S Corp can form Newco LLC as a wholly-owned subsidiary of S Corp. QSub merges into Newco LLC with Newco LLC surviving. Because the merger is between two disregarded entities, this transaction will be disregarded for federal income tax purposes. S Corp can then sell the interests in Newco LLC and qualify for like-kind exchange treatment.<sup>162</sup>

Example. Assume that A has transferred some investment real estate and wishes to do a like-kind exchange. A is a 10% member in Real Estate LLC and B is the unrelated 90% member. Real Estate LLC owns real estate that would qualify as good replacement property for A if A acquired the real estate from Real Estate LLC. What if A instead acquires B’s 90% membership interest? Generally, an LLC membership interest is not good exchange property under Section 1031. However, under Rev. Rul. 99-6<sup>163</sup> B is treated as having sold an interest in an LLC. However, because A will own 100% of the membership interests in Real Estate LLC after the purchase, Rev. Rul. 99-6 treats A as having acquired the underlying assets of the LLC.

Example. Assume that each of A and B owns a 50% membership interest in LLCI. LLCI owns real property held for investment. A and B would like to convey their membership interests in LLCI (to avoid state transfer taxes) and treat this as the disposition of relinquished property under Section 1031. However, the sale of membership interests in an LLC treated as a partnership for tax purposes will not qualify under Section 1031.<sup>164</sup> A and B contribute their membership interests in LLCI to a newly formed entity, LLCII, in exchange for membership interests in LLCII. LLCI becomes a wholly owned subsidiary of LLCII and a disregarded entity. LLCII then conveys 100% of the membership interests in LLCI.

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<sup>157</sup> See e.g., *Magneson v. Commissioner*, 81 TC 767 (1983), *aff’d*, 753 F.2d 1490 (9<sup>th</sup> Cir. 1985); *Bolker v. Commissioner*, 81 TC 782 (1983), *aff’d*, 760 F.2d 1039 (9<sup>th</sup> Cir. 1985).

<sup>158</sup> 1999-1 C.B. 434.

<sup>159</sup> Section 1031(a)(2)(B).

<sup>160</sup> Reg. §1.1361-5(b)(3), Ex. 9.

<sup>161</sup> *But see* section 503 of the Subchapter S Modernization Act of 2003 (H.R. 2576 and S. 1201).

<sup>162</sup> See Reg. §1.1361-5(b)(3), Ex. 2.

<sup>163</sup> 1999-1 C.B. 432.

<sup>164</sup> See section 1031(a)(2)(D).

This structure achieves the objectives of avoiding state transfer taxes and qualifying the disposition for Section 1031 treatment. Under the Section 708 partnership merger rules, LLCII is deemed to be a continuation of LLCI.<sup>165</sup> Thus, LLCII is treated as “holding” the LLCI real property for investment to the same extent as LLCI, qualifying for like-kind exchange treatment.<sup>166</sup>

## **VII. ENTITY OF CHOICE AND ENTITY STRUCTURES FOR SPECIFIC APPLICATIONS**

### **A. The Operating Business**

For most closely held operating businesses where special allocations of income or loss will not be needed, an S corporation would appear to be the entity of choice because it is only subject to one level of taxation (unlike C corporations) and because of the ability to distribute earnings not attributable to services performed by the shareholder-employees as dividends not subject to the self-employment tax (unlike partnerships and LLCs).

### **B. The Professional Practice**

Because of the recent developments discussed above subjecting the earnings of professional practices operating as C corporations to double taxation both under the independent investor test and under the compensatory intent test, and because the sale of assets of a professional practice operating as a C corporation will be subject to double taxation and there can be no assurance of avoidance of double taxation through allocation of a large portion of the sales proceeds to personal goodwill, as well as the ability to make distributions without being subject to the self-employment tax (unlike partnerships and LLCs), the choice of entity for the closely held professional practice would appear to be an S corporation, with the professional partnership or LLC being a close second.

### **C. Structuring Private Equity Fund Investments**

#### **1. General**

Private equity, as referred to in this section, includes venture capital investments in entrepreneurial start-ups, investments in and the financing of growth businesses, leveraged buyouts, management buyouts, and recapitalizations of existing businesses and companies in financial trouble.

Private equity investors and private equity funds actively acquire portfolio investments through the buyout of operating companies from the founder shareholders, as well as from purchases of businesses from diversified companies operating many businesses and subsidiaries and divisions, wishing to divest a non-core business or a business that it is unable to make profitable. These middle market businesses may have been historically operated as C corporations, S corporations, or limited liability companies.

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<sup>165</sup> Reg. §1.708-1(c).

<sup>166</sup> See Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-337, 1977-2 C.B. 305. See also, *Magneson and Bolker, supra.*

The private equity investor hopes that additional capital for expansion, synergy through additional acquisitions, properly incentivized management, and close supervision by sophisticated management, or a combination of these circumstances, will cause the enterprise value of the portfolio company's business and operations to increase geometrically.

Private equity investors are generally willing to expose capital to risk in order to achieve higher rates of return. There are cheaper sources of capital than private equity capital, such as traditional bank loans and private placements of senior debt securities. However, such sources may not be available to an early stage entrepreneur with no proven business plan or collateral or an operating company producing cash flow deficits. Even if traditional financing is available for a portion of the capital required, private equity financing may be necessary to provide the equity base for a business plan to succeed.

Federal law has encouraged private equity investments through various tax and other incentives for over 50 years. The Small Business Investment Act of 1958 permitted banks and bank holding companies to invest in Small Business Investment Corporations (SBICs) subject to certain restrictions.<sup>167</sup> The involvement of banks in private equity investments through the 1960s and 1970s provided the basis for the development of a professional private equity industry in the United States.

Today, participants in private equity transactions include high net worth individuals, merchant banking subsidiaries or divisions of bank holding companies, insurance companies, investment banks, and other large corporations, publicly held and privately held funds formed for the purpose of making private equity investments, and employee pension plans, university endowment funds, and other investors looking for a greater than normal investment return which generally require a high level of risk. Special private equity funds have been formed to permit private investors to diversify their risk among a portfolio of investments, while achieving professional management and oversight of the investments.

An operating company may be reasonably successful, but it may require equity capital from nontraditional private equity sources if traditional financing is not available from bank lenders, or the bank lenders condition credit on the infusion of additional equity capital. The founders may not be ready to sell out to a third party, as they may still have confidence in the original business plan and their ability to execute it. However, without additional private equity, the company may not realize its true potential.

## 2. Structuring Private Equity Investments in an Operating Company

Private equity investors often find profit opportunities in "growth-equity" investments in existing operating companies. The investment capital may be used to fuel expansion, to provide

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<sup>167</sup> An SBIC may invest in a business or "portfolio company" if it meets one of two "size standards" (i) the portfolio company has tangible book net worth (exclusive of intangible assets such as "goodwill") that do not exceed \$18 million and the prior two fiscal years' average net income does not exceed \$6 million, or (ii) the portfolio company meets certain employee or revenue standards published by the SBA for the industry in which it is principally engaged. While an SBIC may continue to invest in a portfolio company after it exceeds the size standards, it must divest itself of control after 7 years (subject to extension with the SBA's approval to complete divestiture of control or to ensure the company's financial stability).



an equity base to support cost effective borrowing from traditional bank lenders, to purchase the stock formerly held by senior founders or their estates, or to recapitalize the current equity and debt structure of the company to provide the foundation for future growth and expansion. The best use of the capital raised from mezzanine and private equity investors is the direct funding of growth and expansion initiatives or strategic acquisitions. In the alternative, mezzanine debt and equity and private equity capital may be raised to buyout original shareholders who no longer contribute to the business plan, or in the case of deceased shareholder, where money is needed to pay estate taxes.

(a) Capital Structure of Operating Company

If a cheaper source of capital were available to the operating company, such as bank financing, asset based lending, or equipment leasing, the founders would take advantage of such sources. However, such sources may have “maxed out” and the founders may be required to seek either (a) subordinated debt, in the form of debt mezzanine capital, or (b) equity, in the form of equity mezzanine capital or pure private equity, from private equity investors.

Debt mezzanine capital may be structured to provide the mezzanine lender with a preferred position through the issuance of subordinated debt, behind senior lenders but ahead of the founders’ equity. In addition, equity may be provided through the issuance of preferred stock by a C corporation (multiple classes of stock are not permitted for an S corporation), preferred LLC or partnership interests, or through the issuance of warrants and convertible debt, discussed further below.

A concern of the mezzanine or private equity investor that must be addressed in the capital structure is maintaining a position that is senior to the equity holders, although junior to the senior lenders, putting them “second in line” to realize any value left in the event of the liquidation of the business. Generally, the private equity investment may be structured through a tax free recapitalization of the operating company. Since the private equity investor does not have control of the company, as in the case of a buy-out, the potential for a successful investment will continue to depend on the business acumen and ability of the existing founders or management group to execute the business plan. The private equity investors will seek to ensure that the management group is properly incentivized to ensure the success of the portfolio company.

There are several ways to recapitalize an existing company to accommodate private equity investments, usually ensuring that the private equity investor has some liquidation preference over the founders. A recapitalization may be accomplished by the transfer of shares in the operating company to a holding company, qualifying as a tax free Section 351 transaction, or the tax free recapitalization of the operating company under Section 368(a)(1)(E) (an “E recap”).

In either a Section 351 transaction or an E recap, there is risk that preferred stock, issued on a non pro rata basis to the passive shareholders in exchange for a substantial block of common stock, will subject the preferred stock to Section “306 stock” treatment. Since the proceeds of the disposition of Section 306 stock is subject to the tax rate of 20% applicable to “qualified dividends,” without reduction for basis, or subject to the dividends received exclusion for a corporate taxpayer, the consequences of the Section 306 taint may not be particularly objectionable.

(b) Avoiding Nonqualified Preferred Stock Treatment for Portfolio Companies Operated as C Corporations

The 1997 Tax Act imposed additional barriers to achieving favorable tax consequences through the use of preferred stock in the capital structure of a C corporation, by defining a new category of preferred stock called “nonqualified preferred stock.” Nonqualified preferred stock is preferred stock that meets any one of four tests:

1. The holder has the right to require the issuer (or a related person) to redeem or purchase the stock within 20 years after the issuance date.
2. The issuer (or a related person) is required to redeem or purchase the stock within 20 years after the issuance date.
3. The issuer (or a related person) has the right to redeem or purchase the stock, and as of the issuance date, it is more likely than not that the right will be exercised within 20 years after the issuance date.
4. The dividend rate on the stock varies in whole or in part with reference to an indexed interest rate, commodity price, or other similar indices, regardless of whether varying the rate is an express term of the stock, or results from other aspects of the stock.

Even if stock qualifies under one of the foregoing tests, it is treated as nonqualified preferred stock only if it is “limited and preferred as to dividends and does not participate in corporate growth to any significant extent.” A shareholder who receives nonqualified preferred stock in an otherwise tax free recapitalization is required to recognize gain (generally long-term capital gain) even where the redemption would have been “essentially equivalent to a dividend” under Section 302 or otherwise subject to treatment as a dividend under Section 301 and eligible for the 20% tax rate for qualified dividends, or the dividend received exclusion in the case of a corporate recipient.

Nonqualified preferred stock is, by definition, not tainted by Section 306 since nonqualified preferred stock is not received by the passive shareholder tax free. A subsequent sale or redemption of the nonqualified preferred stock would not produce Section 306 dividend income to the passive shareholders, although a redemption of nonqualified preferred stock might result in dividend income under Section 302.

(c) Preferred Interest in Portfolio Company Operated as Partnership or LLC

While a preferred interest in an S corporation cannot be obtained by a private equity investor as a result of a single class of stock rules, the investment may be structured to avoid the double tax by issuing the private equity investor a preferred interest in a limited liability company, which may be the historic operating company, or a newly formed LLC or partnership with an S corporation as a member or partner.

While a preferred membership interest in an LLC is not secured and would be lower on the pecking order than subordinated debt, a preferred interest may be one component of the

capitalization structure to ensure the private equity investor that it will “get its money back” with some level of return commensurate with its minimum expectations, while at the same time being ahead of the founder equity investors. Preferred returns and special allocation provisions, common to private equity and venture capital investment transactions, may be drafted into the partnership agreement or the LLC operating agreement.<sup>168</sup>

(d) Unrelated Business Taxable Income for Tax-Exempt Entities

If a portfolio company is organized as a pass-through entity, income tax is avoided at the entity level and passed-through to the private equity investors. Taxable investors pay federal income taxes at the marginal rate applicable after considering all other items of income, loss, deduction, and credit.

Tax-exempt entities, including employee pension plans, are exempt from federal income tax on many items of income. Section 511 imposes tax on the “unrelated business taxable income” or “UBTI” of a tax-exempt entity at regular graduated rates, computed under the same rules applied to domestic corporations.<sup>169</sup> This would include the tax-exempt partner’s share of the UBTI of a partnership or limited liability company.

In addition, Section 514 may cause otherwise exempt interest, dividends or capital gains to be taxed as UBTI if the underlying investment is “debt financed” either as a result of borrowing by the tax-exempt entity, or borrowing by a partnership of which the tax-exempt entity is a partner.<sup>170</sup> While private equity funds seldom borrow or incur acquisition debt, as in the case of a hedge fund, acquisition debt commonly is incurred by a portfolio company. If the portfolio company is a pass-through entity, the debt may “taint” all or portion of any gain on the sale allocable to the tax-exempt investors.

(e) Effectively Connected Income for Foreign Investors.

Foreign persons are subject to federal income tax on income effectively connected with the conduct of a U.S. trade or business (“ECI”). If a treaty applies<sup>171</sup> the IRS must establish that the income in question is “attributable to” a U.S. permanent establishment of the foreign person, in which event the income is subject to tax at the maximum rate of 35%. Absent treaty protection, foreign corporations are subject to the “branch profits tax” on the repatriation of ECI from the United States to the foreign jurisdiction, at a rate of 30%. In effect, foreign corporations are subject to federal tax on ECI at a rate of 54.5%, without regard to state and local taxes.<sup>172</sup>

Like tax-exempt organizations, which are subject to UBTI on business activities of a partnership, foreign persons are subject to tax on ECI attributable to a partnership engaged in

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<sup>168</sup> Section 704(a) provides that a partnership’s share of income, gain, loss, deduction or credit shall, unless otherwise provided, be determined by the partnership agreement. Under Section 704(b), the Service will respect allocations of partnership income or loss provided (i) the allocations have “substantial economic effect,” as further defined in the Regulations, or (ii) taking into account all facts and circumstances, the allocations are in accordance with the “partner’s interest in the partnership.”

<sup>169</sup> Section 511(a)(i).

<sup>170</sup> Reg. §1.514(c-1)(a), example 4.

<sup>171</sup> U.S. Model Income Tax Convention of September 20, 1996, Article 5.

<sup>172</sup> Section 11 and Section 884 (35% plus  $(1 - 35\%) \times 30\% = 54.5\%$ ).

U.S. trade or business and allocable to the foreign person. A foreign person or a partnership in which the foreign person is a partner is subject to tax on ECI upon the sale of an interest in a partnership engaged in a U.S. trade or business.<sup>173</sup> The ECI tax regime is backstopped by the requirement that a partnership that generates ECI must withhold the foreign partner's "applicable percentage" determined under Section 704.<sup>174</sup>

(f) Use of "Blocker" Entities to Avoid UBTI/ECI

Tax-exempt and foreign investors, and funds in which tax-exempt and foreign investors invest, often interpose a corporate "blocker" entity between the investors and the portfolio investment to "trap" the operating profits of the portfolio company within a separate taxable entity. The blocker structure prevents the trade or business activities of the entity from passing through the tiers to the tax-exempt or foreign shareholders. While not resulting in any significant tax savings, the use of a blocker entity avoids the need to report the UBTI and ECI at the investor level.<sup>175</sup> The tax-exempt or foreign investor may avoid the need to file a U.S. tax return otherwise triggered by the EBTI or ECI from a portfolio company investment shielded by the blocker.

Unlike hedge funds, which often structure investments by tax-exempt and foreign investors through offshore entities, private equity funds must deal with the fact that income generated by U.S. based portfolio companies is subject to tax as U.S. source income.

Blocker entities may reside in parallel fund structures, in which the fund invests all capital earmarked for pass-through entities and invested by foreign and tax-exempt investors through a blocker entity, and all other funds directly in the portfolio company. This prevents the other investors (not tax-exempt and foreign investors) from being subject to an additional level of tax at the blocker level. If the fund (or a direct investment in a portfolio company by a foreign or tax-exempt investor) does not involve a blocker in its structure, the tax-exempt or foreign investor may choose to interpose a blocker between the investor and the fund or portfolio investment as a "feeder" organization. If the tax-exempt or foreign investor forms its own blocker, it may domicile the entity in a tax haven jurisdiction to avoid U.S. taxes on income that is not ECI and to avoid U.S. withholding taxes from distributions to the investor by the blocker. The use of a blocker domiciled in a tax haven jurisdiction will permit a tax-exempt investor from being subject to tax on UBTI sourced in a foreign jurisdiction.

The transfer of investments or the structuring of investments to utilize blocker entities by tax-exempt and foreign investors should be respected for federal tax purposes. A corporation should be recognized as a corporation for tax purposes if it is either formed for a substantial business purpose or engaged in substantial business activity.<sup>176</sup> Even if an explicit shareholder purpose is to avoid taxes by the use of the blocker, the blocker corporation should be perceived as carrying out substantive business functions and therefore the corporation should not be ignored as a viable business entity. Similarly, the IRS should not be able to assert that the

<sup>173</sup> See Rev. Rul. 91-32, 1991-1 C.B.107.

<sup>174</sup> Section 1446(a).

<sup>175</sup> The indirect tax burden incurred by the investors at the blocker level will roughly approximate the tax that the tax-exempt or foreign investor would have paid on the UBTI or ECI.

<sup>176</sup> Moline Properties v Commissioner, 319 U.S. 436 (1943).

shareholders formed or acquired control of the blocker for “tax avoidance” purposes under Section 269 of the Code. In a parallel fund structure, shareholder use of the blocker may be sufficiently dispersed to avoid the “control” test of Section 269. In addition, the blocker structure may achieve only marginal tax savings for the shareholders, serving primarily to downstream the tax return filing requirements or to facilitate the later sale of stock in the blocker entity. As a separate corporation, the blocker will always bear full corporate tax on its ECI, and in the case of a domestically formed blocker, on its worldwide income.

(g) Limitations on the Use of Debt to Minimize Corporate Tax (“Earnings Stripping”)

The use of senior and subordinated acquisition debt on favorable terms may provide the private equity investor with the opportunity to generate tax deductions at the entity level and increase the overall return on capital deployed in a portfolio company acquisition. The senior financing may be provided by a traditional lender. Subordinated debt financing may be used by the private equity investor to create interest deductions and “strip” corporate earnings from a C corporation. Earnings stripping is subject to numerous limitations, including: (i) the proposed debt/equity regulations under Section 385 (discussed further below), (ii) the original interest discount (“OID”) rules requiring the amortization of the debt holder’s interest income over the life of a debt obligation on a constant yield to maturity basis,<sup>177</sup> (iii) the Section 279 limitations on interest on convertible and nonconvertible debentures accompanied by warrants to acquire equity, (iv) the Section 163(e)(5) limitations applicable high yield discount obligations (“AHYDO”) involving debt instruments issued by C corporations with a maturity of more than 5 years after issuance and OID and payment in kind (“PIK”) features with a yield equal or in excess of 5 percentage points over the applicable federal rate (“AFR”), (v) the Section 163(j) limitations on interest payable to or guaranteed by a related lender, and (vi) the Section 163(l) limitation on equity linked debt where there is a substantial certainty that an option to convert the debt into equity will be exercised.

Each of these limitations and the proposed Section 385 Regulations must be carefully navigated where debt is used in the capital structure of a private equity investment through a C corporation, regardless of whether the use of debt is tax motivated.

On April 4, 2016, Treasury and the Service released proposed regulations under Section 385.<sup>178</sup> If finalized in their current form, the Proposed Regulations would make sweeping changes to the characterization of instruments issued by a corporation to a related party that were previously treated as indebtedness under current law.

The Proposed Regulations consist of three sets of rules. First, the Bifurcation Rule provides that the Service may treat certain instruments that are in the form of debt as in part indebtedness and in part stock to the extent they are properly treated as such under general debt/equity testing principles.<sup>179</sup> In particular, the Bifurcation Rule can potentially apply to any expanded group instrument (“EGI”), as modified by Prop. Reg. § 1.385-1(d)(1). The term “expanded group” generally refers to an affiliated group as defined in Section 1504(a), with certain

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<sup>177</sup> Sections 1272 and 1273.

<sup>178</sup> See Notice of Proposed Rulemaking, 81 Fed. Reg. 20,914.

<sup>179</sup> See generally Prop. Reg. § 1.385-1(d), 81 Fed. Reg. 20,912, 20,931 (2016).

modifications to expand its scope, including by counting indirect stock ownership under the rules of Section 304(c)(3). The term “modified expanded group” is defined in the same manner as the expanded group, but adopting a 50% ownership threshold, and adding further potential noncorporate members. An EGI is an instrument that is in form a debt instrument issued by a member of an expanded group and held by a member of the same expanded group.<sup>180</sup> Prop. Reg. § 1.385-1(d)(2) modifies the definition of EGI to apply to instruments issued and held by members of a modified expanded group.<sup>181</sup>

Second, the Documentation Rule provides that an EGI is treated as stock for U.S. federal income tax purposes if certain documentation and information requirements are not satisfied.<sup>182</sup>

Third, the Proposed Regulations provide a regime whereby certain instruments that would otherwise be treated as indebtedness for U.S. federal income tax purposes are instead treated as stock of the issuer to the extent such instruments are issued in certain specified transactions or issued with a principal purpose of funding, or are treated by the Proposed Regulations as being issued with a principal purpose of funding, such specified transactions.<sup>183</sup>

#### **D. Real Estate Investments**

##### **1. Advantages of Partnerships and Limited Liability Companies to Hold Real Property**

Limited partnerships and LLCs taxed as partnerships and disregarded entities, are ideally suited for holding real property for a number of reasons.

(a) *Limited Liability for Investors.* Most real estate investors want to avoid potential personal liability as a result of their ownership of real estate while at the same time having some control over the development, operation and disposition of the real estate. Prior to the advent of LLCs, limited partnerships were commonly used. In structures involved the developer, who often contributes little money as the general partner while the limited partners contribute capital to the partnership as limited partners. The developer would often set up a separate corporation, perhaps electing S corporation treatment, to serve as the general partner in order to try to limit the general partner’s personal liability. The limited partners could have only limited say in the management of the business if they wanted to avoid personal liability for the obligations of the partnership. Limited partnerships and even general partnerships are often used to hold real estate used in special situations.

(b) *Avoiding Cumbersome Structures.* The LLC avoids cumbersome structures required in the case of limited partnerships with corporate general partners. The developer can individually be a member and manager of the LLC without subjecting himself to personal liability and therefore can avoid the extra administrative costs and hassles of setting up a corporation to serve as general partner in order to avoid personal liability. In addition, the investor members can

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<sup>180</sup> Prop. Reg. §§ 1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

<sup>181</sup> Prop. Reg. §§ 1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

<sup>182</sup> See generally Prop. Reg. § 1.385-2, 81 Fed. Reg. at 20,931.

<sup>183</sup> See generally Prop. Reg. § 1.385-3, 81 Fed. Reg. at 20,934.

have much more control over their investments without risking personal liability (except, of course, to the extent a lender may require personal guarantees).

(c) *Avoiding Double Taxation.* Many real estate investors do not want to hold real property in a regular C corporation in order to avoid a possible double tax on the appreciation of the real estate when the real estate is ultimately sold or distributed to the owners. This “double taxation” (taxation at both the corporate and shareholder levels) of the appreciation in real estate is a significant disadvantage to the holding of real estate by a C corporation.

(d) *Pass-through Losses of Real Estate.* If the real estate investment is generating losses through depreciation, interest or other deductions and is held by a C corporation rather than a pass-through entity such as an LLC (that has elected to be taxed as a partnership), a partnership or an S corporation, the losses will not be available to offset other income of the C corporation shareholder. However, the basis, at-risk and passive loss rules may also restrict the LLC member from using the LLC losses to offset other income of the member.

(e) *Avoiding Limitations on Type and Number of Owners; Special Allocations; Basis for Entity Level Debt.* While an S corporation avoids the double taxation issue, it has other disadvantages for holding real estate when compared to an LLC. S corporations have restrictions on the type and number of shareholders. In addition, S corporations may not have a second class of stock, which may be deemed to be the case if preferred returns or special allocations are utilized in structuring the real estate investment. Also, an S corporation shareholder is not allowed to add the shareholder’s proportionate share of the corporation’s debt to the shareholder’s stock basis, which may result in losses not being utilized, while the opposite is often true for a partner or a member of an LLC. This ability to use the debt of the entity to increase the owner’s basis in his investment and therefore utilize his proportionate share of loss from the entity is often very important to real estate investors.

(f) *Like kind Exchanges.* As discussed in III F above, taxpayers can structure like kind exchanges with disregarded entities as special purpose holding companies using single member LLCs.

## 2. Private REIT Structures

While limited partnerships and LLCs are generally the preferred vehicles for private investment in real estate, private REITs may provide significantly better tax results in certain circumstances

### (a) REIT Organizational Requirements

A REIT is a “real estate investment trust” governed by Sections 656 through 659 of the Code. REITs must meet certain requirements relating to organization, sources of income, nature of assets, distributions of income to stockholders and recordkeeping. While many REITs are publicly held, strictures involving “private REITs” are quite common. In order to qualify, and continue to qualify for taxation as a REIT under the Code, an entity must:

- be a taxable domestic corporation but for Sections 856 through 859 of the Code;

- be managed by one or more trustees or directors;
- have transferable shares;
- not be a financial institution or an insurance company;
- have at least 100 stockholders for at least 335 days of each taxable year of 12 months;
- not be closely held (the “5 or fewer test, discussed further below);
- elect to be a REIT, or make such election for a previous taxable year, and satisfy all relevant filing and other administrative requirements established by the IRS that must be met to elect and maintain REIT status;
- use a calendar year for federal income tax purposes and comply with the recordkeeping requirements of the federal tax laws;
- distribute all earnings and profits attributable to a taxable year in which we do not qualify as a REIT by the end of the first year as a REIT; and
- meet certain other tests, described below, regarding the nature of income and assets.

Private REITs deal with the 100 shareholder requirement in several ways. One approach is to find 99 friends and family members, as there is no attribution limitation. Another approach is to issue non-voting preferred shares to between 115 and 125 investors. Shares are typically priced at U.S. \$1,000, are subject to redemption at par plus accrued but unpaid dividends, and pay a fixed dividend. A limited number of these preferred shares are sold, and often no more than \$125,000 is invested in these shares in the aggregate. A “rent your REIT shareholders” industry has emerged to facilitate the investment by preferred holders and manage investor relations. The convenience of a specialized company can be helpful because it has the procedures in place to track the investors as they change over time.

The non-closely held requirement is also a concern for private REITs. A REIT will lose its favorable U.S. tax classification if 5 or fewer individuals collectively own more than 50%, by value, of the REIT’s shares. Ownership is tested by looking up through the chain of direct and indirect ownership, with shares owned by entities generally treated as if owned proportionately by their equity holders. As a result of these look-through rules, it is necessary to restrict transfers of both directly and indirectly held REIT shares. Because the consequences of loss of REIT status are so dire – the corporation becomes fully taxable on its income and sales of its shares are fully taxable to international shareholders - these restrictions are generally enforced by bylaw and charter restrictions. Thus, it is common for REIT organizational documents to limit the ownership of any one shareholder to 9.9% of the equity interests in the REIT. Therefore, no group of five shareholders can own more than 50% of the equity interests in the REIT.

In the case of a REIT that is a partner in a partnership, the Regulations provide that the REIT is deemed to own its proportionate share, based on its interest in partnership capital, of the assets of the partnership and is deemed to have earned its allocable share of partnership income. Also, if a REIT owns a qualified REIT subsidiary, which is defined as a corporation wholly-owned by a REIT that does not elect to be taxed as a taxable REIT subsidiary under the Code, or owns all of the interests in an unincorporated domestic entity, such as a limited liability company, which is generally treated as a disregarded entity for federal income tax purposes, the REIT will be deemed to own all of the qualified REIT subsidiary’s or other disregarded entity’s assets and liabilities and



it will be deemed to be entitled to treat the income of that entity as its own. In addition, the character of the assets and gross income of the partnership, qualified REIT subsidiary or other disregarded entity shall retain the same character in the hands of the REIT for purposes of satisfying the gross income tests and asset tests set forth in the Code.

(b) Income Tests for REIT Status

To qualify and maintain qualification as a REIT, an entity must on annual basis satisfy the following gross income requirements:

At least 75% of gross income, including dividends from a subsidiary REIT, but excluding gross income from prohibited transactions and dividends from any corporate subsidiaries including any REIT subsidiary that fails to qualify as a REIT, for each taxable year must be derived directly or indirectly from investments relating to real property or mortgages on real property or qualified temporary investment income. Qualifying income for purposes of that 75% gross income test generally includes rents from real property, interest on debt secured by mortgages on real property or on interests in real property, dividends or other distributions on, and gain from the sale of, shares in other REITs, gain from the sale of real estate assets, income derived from the temporary investment of new capital that is attributable to the issuance of shares of common stock or a public offering of debt with a maturity date of at least five years and that we receive during the one-year period beginning on the date on which we received such capital, gross income from foreclosure property, and income derived from the temporary investment of new capital that is attributable to the issuance of stock or a public offering of debt with a maturity date of at least five years and that we receive during the one-year period beginning on the date on which we received such new capital.

Gross income from dispositions of real property held primarily for sale in the ordinary course of business is excluded from the 75% Income Test. Such dispositions are referred to as “prohibited transactions.”

In general, at least 95% of gross income for each taxable year must consist of income that is qualifying income for purposes of the 75% gross income test, other types of interest and dividends or gain from the sale or disposition of stock or securities. This is known as the 95% Income Test. Income and gain from “hedging transactions” that we enter into to hedge indebtedness incurred or to be incurred to carry real estate assets and that are clearly and timely identified as such also will be excluded from both the numerator and the denominator for purposes of the 95% Income Test and the 75% gross income test.

Rents qualify as “rents from real property” for purposes of satisfying the gross income requirements for a REIT only if the following conditions are met:

First, the amount of rent received from a tenant generally must not be based in whole or in part on the income or profits of any person; however, an amount received or accrued generally will not be excluded from the term “rents from real property” solely by reason of being based on a fixed percentage or percentages of gross receipts or sales if such amount is in conformity with normal business practice and not used as a means to base rent on income or profits;

Second, rents received from a tenant will not qualify as “rents from real property” if we or a direct or indirect owner of 10% or more of the REIT directly or constructively owns 10% or more of the tenant except that rents received from a taxable REIT subsidiary under certain circumstances qualify as rents from real property even if the REIT owns more than a 10% interest in the subsidiary;

Third, if rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as “rents from real property;” and

Fourth, the REIT may not manage or operate the property or furnish or render services to tenants, other than through an “independent contractor” who is adequately compensated and from whom we do not derive any income. However, the REIT may provide services with respect to its properties, and the income derived therefrom will qualify as “rents from real property,” if the services are “usually or customarily rendered” in connection with the rental of space only and are not otherwise considered “rendered to the occupant.” Even if the services with respect to a property are impermissible tenant services, the income derived therefrom will qualify as “rents from real property” if such income does not exceed 1% of all amounts received or accrued with respect to that property. Services generally are deemed not to be provided by the REIT if they are provided through (i) an “independent contractor” who is adequately compensated and from whom the REIT does not derive revenue or (ii) a taxable REIT subsidiary.

A “taxable REIT subsidiary” is a subsidiary of a REIT that makes a joint election with the REIT to be treated as a taxable REIT subsidiary. The separate existence of a taxable REIT subsidiary or other taxable corporation, unlike a “qualified REIT subsidiary” or other disregarded entity, is not ignored for U.S. federal income tax purposes. Accordingly, a taxable REIT subsidiary is generally subject to corporate income tax on its earnings, which may reduce the cash flow generated by such entity. Because a parent REIT does not include the assets and income of a taxable REIT subsidiary in determining the parent’s compliance with the REIT qualification requirements, a taxable REIT subsidiary may be used by the parent REIT to undertake activities indirectly that the REIT might otherwise be precluded from undertaking directly or through pass-through subsidiaries. Certain restrictions imposed on taxable REIT subsidiaries are intended to ensure that such entities and their parent REITs will be subject to appropriate levels of U.S. federal income taxation.

A REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee in possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor under certain specific safe harbors.

(c) Asset Tests for REIT Status

At the close of each quarter of the taxable year in which an entity is taxed as a REIT, the entity must satisfy the following tests relating to the nature and diversification of its assets:

First, at least 75% of the value of the total assets must be represented by real estate assets, cash, cash items, and government securities. The term “real estate assets” includes real property, mortgages on real property, shares in other qualified REITs and a proportionate share of any real estate assets owned by a partnership in which we are a partner or of any qualified REIT subsidiary of ours.

Second, no more than 25% of total assets may be represented by securities other than those in the 75% asset class.

Third, of the investments included in the 25% asset class (other than stock of a taxable REIT subsidiary), the value of any one issuer’s securities may not exceed 5% of the value of total assets. Additionally, the entity may not own more than 10% of any one issuer’s outstanding securities (based on either voting rights or value), except in the case of taxable REIT subsidiaries.

Finally, the value of all of the securities of taxable REIT subsidiaries may not exceed 25% of the value of total assets. Under the PATH Act, effective for tax years beginning after December 31, 2017, the securities of one or more TRSs held by a REIT may not represent more than 20% (rather than 25% under current law) of the value of the REIT’s assets.

For purposes of the 5% and 10% asset tests, the term “securities” generally includes debt securities issued by a partnership or another REIT, except that for purposes of the 10% value test, the term “securities” does not include “straight debt,” as defined by the regulations.

(d) REIT Distribution Requirements

In order to be taxed as a REIT, an entity is required to make distributions, other than capital gain distributions, to stockholders each year in the amount of at least 90% of REIT taxable income, which is computed without regard to the dividends paid deduction and net capital gain, and is subject to certain other potential adjustments. Distributions with respect to a taxable year to which they relate may be paid in the following taxable year if they are (1) declared before the timely filing of a U.S. federal income tax return for the taxable year in question, and if (2) made on or before the first regular distribution payment date after the declaration.

If an entity satisfies the foregoing distribution requirements and, accordingly, continue to qualify as a REIT for tax purposes, the entity will still be subject to tax on the excess of its net capital gain and REIT taxable income, as adjusted, over the amount of distributions made to stockholders.

If a REIT elects to retain, rather than distribute, its net long-term capital gains, the REIT would be required to pay the tax on these gains, the stockholders, while required to include their proportionate share of the undistributed long-term capital gains in income, would receive a credit or refund for their share of the tax paid; and the basis of a stockholder’s shares would be increased by the difference between the designated amount included in the stockholder’s long-term capital gains and the tax deemed paid with respect to such shares.

(e) REITs Structured as Joint Ventures

In many cases, additional flexibility may be obtained by forming a joint venture in the form of a partnership or LLC to own all of the common shares of the REIT. A joint venture entity allows easier navigation of the various REIT qualification rules and the investors' economic and control objectives.

*Free Transferability.* The joint venture can limit the transferability of its common shares so that the parties can control who their partners are. REITs cannot achieve this directly, because their shares are required to be freely transferable.

*Complex Waterfalls, Including Preferred Returns.* While distribution waterfalls can be affected through multiple classes of stock in a corporate structure, a more tax efficient distribution waterfall can be drafted using a joint venture taxed as a partnership. This is particularly the case where priority preferred returns and catch-ups are desired or where there are "clawback" provisions.

*Preferential Dividends.* REITs are prohibited from paying preferential dividends, which include dividends at different rates on the same class of shares. Where the REIT is owned by a joint venture, different dividend rates and fee loads can be accomplished at the joint venture level without risking disqualification of the REIT.

*Management.* Joint ventures are more flexible and can bind the entity more effectively than similar provisions in a corporate context. REITs require "centralized" management. In the typical joint venture, there is an "operating" partner or manager and a number of "major decisions" that require the approval of the larger investors. Those investors may insist on the right to force a sale or refinancing and often will also require their consent be obtained for any sale or refinancing proposed by the operator. While these limitations can be accomplished in a centralized management environment, the mechanisms to accomplish this are often cumbersome and formalistic. Addressing the resolution of an impasse and other similar joint venture management issues is also much more difficult in practice, if achievable at all, if the investors invest directly in the REIT rather than through a joint venture.

(f) Tax Advantages of REIT Structures for Foreign Investors in U. S. Real Estate

An international investor who owns U.S. real estate (directly or through a flow-through or "fiscally transparent" entity for U.S. tax purposes) generally is required to file state income tax returns in each state in which the U.S. real estate is located, in addition to a federal income tax return. To avoid these U.S. tax filing obligations, international investors often make their investment in U.S. real estate through a U.S. corporation, typically referred to as a "blocker," because it blocks these filing obligations and imposes them on the U.S. corporation instead. A REIT is a corporation for this purpose and as such generally serves to minimize U.S. tax filing obligations.

As a practical matter, REITs generally distribute all of their taxable earnings to avoid corporate-level income taxes on any undistributed taxable earnings. Generally, a U.S. corporation that is not a REIT is taxable on all of its income, whether from operations or capital transactions, with a top federal rate of 35% plus state and local taxes that vary significantly,

depending on the state (and sometimes the city) where the corporation's property is located. REITs, however, are subject to a special tax regime under which distributions to shareholders are deductible in computing taxable income, effectively eliminating corporate taxes at the REIT level. To qualify as a REIT, the REIT must distribute at least 90% of its taxable non-capital gain income to its shareholders each year and, further, any undistributed earnings, whether ordinary or capital, are subject to corporate tax. The net result is that REITs distribute all or nearly all of their operating income and gains each year to their shareholders. Distributions by REITs to their shareholders are characterized as dividends under U.S. law and most treaties. Most dividends paid to foreign shareholders are subject to U.S. tax at a flat 30% rate. Although that rate may be (and often is) reduced by treaty, REIT dividends may be subject to a less favorable withholding rate than regular dividends. A "consent dividend" provides an opportunity for the REIT to be treated as making a dividend for tax purposes without the need to actually distribute cash.<sup>184</sup>

Capital gains and certain other types of income are subject to special treatment and are not included for the purpose of applying the 90% test. Capital gains are not required to be distributed, but any undistributed capital gains are subject to taxation at applicable corporate rates. As a result, it is very rare for public and private REITs not to distribute all capital gains. The rationale for this distinction is that a REIT, unlike a regular corporation, normally does not pay tax at the entity level and thus does not need a lower withholding tax rate on its dividends to mitigate double taxation.

Although most REIT dividends will be taxed at a flat 30% or lower treaty rate (if applicable), to the extent that the source of the dividend is gain from the sale of U.S. real estate, the dividend is subject to tax under FIRPTA. The amount subject to FIRPTA tax is the amount designated by the REIT as a capital gain dividend. Foreign investors receiving designated capital gain dividends are taxable on those dividends in the U.S. at graduated federal income tax rates. If the international investor is a corporation, the corporate rates apply (which is generally 35%). Specifically, the Foreign Investment in Real Property Tax Act ("FIRPTA") generally provides that income and gain from the disposition of U.S. real estate must be subjected to U.S. tax. FIRPTA treats capital gain dividends from REITs that are not domestically controlled as "effectively connected income," which is subject to tax at normal graduated U.S. rates.

If the real estate is held by a corporation (such as a REIT), these rules also taint the sale of the corporate stock if the corporation is a United States Real Property Holding Corporation ("USRPHC"). In general, a corporation is considered a USRPHC if 50% or more of the gross value of a corporation's assets in the year of sale or in any of the previous five years is attributable to U.S. real estate. Equity REITs are, by definition, USRPHCs, because investments in U.S. real estate represent far more than 50% of the gross value of their assets. As a result, the sale of the stock of a REIT by a foreign shareholder is subject to U.S. tax unless the REIT is exempt from USRPHC status. FIRPTA grants this exemption to domestically controlled REITs.<sup>185</sup> Where this exemption applies, a foreign shareholder is not taxed on the sale of its REIT stock. Therefore, sophisticated international investors prefer to invest through private domestically controlled REITs.

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<sup>184</sup> See sections 561(a) and 565.

<sup>185</sup> A domestically controlled REIT is owned 50% or more in value, directly or indirectly, by U.S. shareholders.

(g) Tax Advantages of REIT Structures for Tax Exempt Investors

Tax exempt organizations, such as retirement plans, charities, and private foundations, are not subject to federal income tax on investment income, but are subject to federal income tax on “unrelated business taxable income” or UBIT, including income arising from debt finance property. Real estate investments are often debt financed. A REIT is not subject to tax on UBIT, and significantly, the UBIT does not flow through to a tax exempt investor. An exception to this rule applies if pension investors hold more than 25% of the equity interests in a REIT (a “pension held REIT”), in which case the tax exempt investors are subject to the UBIT rules. This is often avoided by prohibiting tax exempt investors from owning more than a specified percentage of the equity interests of a REIT.

(h) State Income Tax Considerations of REITs

REITs may also be used to minimize state income taxes for investments in real estate located in high tax states, where the REIT is not subject to tax on income sourced in the state, and the income is distributed to shareholders residing in low tax states.

3. The UPREIT Structure

An umbrella partnership real estate investment trust (“UPREIT”) involves a structure where a REIT holds all or substantially all of its properties through an operating partnership. The structure allows property owners to contribute properties to the operating partnership in exchange for ownership units in the operating partnership (“OP Units”). The OP Unit Holders recognize no gain on the transaction under section 721, which does not require “control immediately after” the transfer as in the case of a section 351 transfer. Real estate contributed directly to the REIT would be a taxable event for the contributing property owner and a stepped up basis in the property held by the REIT. However, by contributing the property to the operating partnership instead of the REIT, the contributing property owner’s historical cost basis is maintained.

The operating partnership generally avoids classification as a publicly-traded partnership either because (i) at least 90% of such partnership's gross income for a taxable year consists of “qualifying income” under Section 7704(d) of the Code, or (ii) the OP Units are not publicly traded. For purposes of the first test, qualifying income generally includes any income that is qualifying income for purposes of the 95% Income Test applicable to REITs. Under the second test, a safe harbor provides that interests in a partnership will not be treated as readily tradable on a secondary market or the substantial equivalent thereof if (i) all interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the Securities Act, and (ii) the partnership does not have more than 100 partners at any time during the partnership's taxable year. In determining the number of partners in a partnership, a person owning an interest in a flow-through entity, such as a partnership, grantor trust or S corporation, that owns an interest in the partnership is treated as a partner in such partnership only if (a) substantially all of the value of the owner's interest in the flow-through is attributable to the flow-through entity's interest, direct or indirect, in the partnership and (b) a principal purpose of the use of the flow-through entity is to permit the partnership to satisfy the 100 partner limitation.

The primary incentive for a selling property owner in entering into an UPREIT transaction is that it can be completed on a tax deferred basis. The owner of the property being contributed to the operating partnership does not recognize immediate gain on the transaction because the owner does not acquire shares of stock in the REIT, but rather receives OP Units in the REIT's operating partnership. In addition, if the OP Units end up in the owner's estate, the ultimate recipients of the OP Units will receive a stepped-up basis equal to the value at death and the inherent gain resulting from the UPREIT transaction will not be subject to capital gains or income tax. The tax deferral or avoidance, as the case may be, gives REIT's utilizing the UPREIT structure a large advantage over cash purchasers of real estate.

Another benefit of an UPREIT transaction is that, in becoming an OP Unit Holder, the property owner essentially converts an interest in one or more specific properties into an interest in a larger and more balanced portfolio of properties. The operating partnership's portfolio is often diversified as to property type and geography, and usually benefits from the economies of scale and management that a larger entity can offer.

An UPREIT transaction may allow an interest in illiquid real estate properties to become more easily saleable by providing that the OP Units may be converted, subject to minor restrictions, on a one-for-one basis for shares of common stock of the private or publicly-traded REIT. While such a conversion to stock may trigger recognition of taxable gain, the flexibility permits the owner to unlock value and access capital as needed.

The capital gain is deferred as long as the operating partnership holds the property and the OP Unit Holder holds the OP Units. In other words, capital gains taxes become due if: (a) the OP Unit Holder exchanges the OP Units for REIT shares; (b) the OP Unit Holder exchanges the OP Units for cash; or (c) the subject property is sold by the operating partnership, when the gain is allocated to the contributing partner under section 704(c). Even in the last case, the operating partnership can sell the property as part of a Section 1031 exchange and avoid the trigger of gain to the OP Unit Holders that contributed the property being sold.

From an economic standpoint, OP Units are structured to be indistinguishable from shares of common stock in the REIT. OP Units are equal in value to REIT shares and fluctuate in value in the same way. However, OP Units do not carry the same voting rights as shares in the REIT, and OP Unit holders are not shareholders of the corporation electing REIT status.

While OP Unit holders receive distributions equal to the dividends paid on REIT shares, OP Units and REIT shares are taxed differently for income tax purposes. An OP Unit holder is deemed to earn a portion of the total income of the operating partnership, including income from each of the states in which it transacts business. Thus, OP Unit holders have income tax filing requirements in each state the operating partnership transacts business. REIT shares, on the other hand, generate income that is taxable only in the shareholder's state of residency, which means only one state tax return must be filed.

## **E. Structuring Parent Subsidiary Arrangements**

### **1. Consolidated Return for Parent Subsidiary Corporations.**

The C corporation has historically been considered to be the preferred choice if it is desirable to operate several businesses and separate corporations owned by a common parent or to operate separate subsidiaries in different states. By filing a consolidated return, the taxable income of profitable businesses may be offset by the losses of unprofitable businesses.

Section 1504 provides that an “affiliated group” eligible to file consolidated corporate tax returns consists of one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, if: (a) the common parent owns directly stock meeting the requirements of Section 1504(a)(2) in at least one of the other includible corporations, and (b) stock meeting the requirements of Section 1504(a)(2) in each of the includible corporations, excluding the common parent, is owned directly by one or more of the other includible corporations.

Section 1504(a)(2) requires that in order for an includible corporation to be a member of an affiliated group there must be ownership of stock possessing at least 80% of the total voting power of the stock of the includible corporation (the “vote” test) and ownership of stock of the includible corporation having a value at least equal to 80% of the total value of the stock of such corporation (the “value” test), by a common parent corporation.

Associations and trusts taxable as corporations, and LLCs and partnerships electing to be taxed as corporations under the check-the-box rules are includible corporations. Similarly, corporations that are inactive or bankrupt are includible corporations. Partnerships and LLCs taxable as partnerships as well as S corporations, are not includible corporations.

An affiliated group may consist simply of a parent and a subsidiary, a parent and several first-tier subsidiaries, or any combination of multiple tiers of subsidiaries, provided that the vote and value tests are satisfied with respect to each includible corporation and the chain of stock ownership is not broken by an intervening non-includible corporation. Therefore, no corporation that is owned by a non-includible corporation can be a member of the basic affiliated group. However, an includible corporation owned by the non-includible corporation may form its own separate affiliated group if the tests of Section 1504(a) are met as to it and other directly connected includible corporations.

## 2. The Single Member LLC.

As noted in the discussion of disregarded entities, a single member LLC is an attractive vehicle for structuring parent-subsidiary arrangements, providing limited liability for the parent and qualifying for tax treatment similar to members of a consolidated return. Assets may be moved around without tax consequences or the complications of intra group spinoff in a consolidated group setting.