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Business, Benefits and Tax Issues Involved in the Formation and Structure of the Closely Held Business Selection of Entity Considerations

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BUSINESS, BENEFITS AND TAX ISSUES INVOLVED IN THE FORMATION AND STRUCTURE OF THE CLOSELY HELD BUSINESS
SELECTION OF ENTITY CONSIDERATIONS

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I. INTRODUCTION


The Jobs and Growth Tax Relief Reconciliation Act of 20031 (the “2003 Act”) revised the individual income tax rates and the tax rates applicable to dividends, giving rise to reconsideration of many of the basic principles underlying the choice of business entity.

The 2003 Act reduced the marginal tax rates applicable to high income taxpayers, effective in 2003 through 2009. Corporate rates are no longer significantly lower than individual rates, and in some cases they are higher. The reduced rates “sunset” after 2010. The Bush Administration’s “dividend exclusion” proposal as originally proposed, would have substantially eliminated double taxation on distributed corporate earnings. As enacted, Section 302 of the 2003 Act the provision merely reduces the tax rate on “qualifying dividends” received by individuals between January 1, 2003 and December 31, 2008 to a maximum of 15%, only to return to 2002 levels as of January 1, 2009. Because the 2003 legislation favored a lower tax on dividends over the “dividend exclusion” approach, its impact on choice of entity decisions is not as profound as it might have been. Had the 2003 legislation embraced the “dividend exclusion” proposal, the preference for S corporations partnerships, limited liability companies (with a single level of taxation) over C corporations would have diminished considerably. As enacted, however, the Act merely reduces the tax rates on qualified dividends, with the consequence that the pass through entities remain the preferred choice under most circumstances, in light of the exposure of C corporation earnings to two levels of tax.

The advent of the “disregarded entity” further advances the quest for pass through treatment in the choice of entity. A limited liability company with a single member is treated as

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a disregarded entity for income tax purposes unless it elects corporate status. The single member of an LLC may be a partnership, another LLC, an S corporation, a C corporation, or even another single member LLC. A wholly-owned subsidiary of an S corporation may elect qualified subchapter S subsidiary or "Qsub" status and operate a division of the S corporation parent as a disregarded entity. A Qsub may be the single member of an LLC. The menu for the pass through connoisseur is a delightful one.

B. Implications of Tax Rate Reductions on the Quest for the Pass Through Treatment.

When the maximum marginal individual income tax rate was increased to 39.6% (reduced to 38.6% for 2002 by the Economic Growth, Tax Relief and Recovery Act of 2001 ("EGTRRA-2001"), the individual rate exceeded the corporate rate. The maximum marginal individual income tax rate was reduced to 35% for 2003 through 2010 by the 2003 Act, equaling the maximum corporation rate.

The reduction of the tax rate on dividends to 15%, equal to the capital gains rate, was a significant change. Prior to EGTRRA-2001 and the 2003 Act, the combined corporate and individual maximum income tax rate imposed on corporate earnings of a C corporation to be distributed to shareholders was 60.74% (obtained by multiplying a hypothetical $100 of earnings by the maximum corporate tax rate of 35%, leaving $65, which when distributed as a dividend would result in a shareholder level tax of $25.74 ($65 x 39.6%) or an aggregate tax of $60.74). After the 2003 Act and the maximum individual tax rate of 15% on dividends, the combined corporate and individual income tax rate is 44.75%.

Assuming that the business owner would have qualified for long term capital gains treatment and a maximum individual rate of 20% upon sale or liquidation of the business, the aggregate corporate and individual tax rate prior to EGTRRA-2001 and the 2003 Act was 48% ($35 of corporate tax and $13 of individual tax ($65 x 20%)). After the 2003 Act and a maximum rate of 15% for net capital gains taken into account after May 5, 2003, the combined corporate and individual income tax rate is 44.75%. Until the 15% tax rate on dividends and capital gain sunsets after 2008, there is less incentive to distinguish between dividend and sale or exchange treatment for corporate distributions.

II. TAXATION OF QUALIFIED DIVIDENDS UNDER THE 2003 ACT

A. Definitions.

The consequences of the choice of a C corporation as the business entity, and the potential of a double level tax, is softened by the 15% tax rate for dividends received by individuals under the 2003 Act. After the amendments to the Code by the 2003 Act (effective January 1, 2003), the term "qualified dividend income" means dividends received during the taxable year from domestic corporations and qualified domestic foreign corporations received by a non-corporate taxpayer (i.e., a taxpayer whose capital gain income is subject to section 1(h)). Dividends received by corporate taxpayers are eligible for a special deduction of 70 percent or 100 percent under section 243. A dividend is a distribution from the corporation's current or accumulated earnings and profits ("E&P").

Section 1(h)(11)(B)(i)(I) and (II).
Qualified dividends do not include: (1) Any dividend from a tax-exempt corporation;\(^3\) (2) any tax deductible dividend paid by mutual savings bank;\(^4\) (3) any deductible dividend paid by a C corporation with respect to employer securities in a qualified plan that is paid to the plan participants;\(^5\) (4) any dividend paid with respect to stock held by the shareholder for less than 60 days during the 120-day period beginning 60 days before and ending 60 days after the ex-dividend date;\(^6\) and (5) any dividend paid by a RIC or REIT to the extent deductible in computing the table income of such entity.\(^7\)

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

B. Reduced Tax Rate on Qualified Dividends.

Both common and preferred dividends from closely held and public corporations will qualify for the 15% rate. S corporation distributions from CE&P, amounts treated as ordinary income under section 306, and amounts treated as dividends under sections 302, 304, and 305 will qualify for the 15% rate.

Taxpayers and the IRS may find themselves on the opposite sides of the traditional debt-equity argument. In particular, the IRS might argue that some preferred stock should be treated as debt by the IRS. If the corporation is entitled to claim an interest deduction, then the shareholder should not be eligible for the 15% rate.

The legislative history suggests that the IRS will issue guidance with respect to information reporting on Form 1099 on dividends, as well as substitute or in lieu dividend. For 2003, taxpayers are permitted to rely on the Form 1099s to report the amount eligible for reduced rates. The Conference Report states that the IRS will issue guidance on information reporting with respect to payments in lieu of dividends to individuals. A revised Form 1099-DIV has been released requiring brokers to report separately total ordinary dividends, and that portion of those dividends that constitute qualified dividends. Form 1099-MISC already contains a box for reporting substitute dividends. The conference report states that individual taxpayers who receive substitute dividends may treat the payments as dividend income to the extent that the payments are so reported on Form 1099-DIV for 2003, unless they have reason to know that they are substitute payments. The distinction between actual and substitute dividends will now be relevant. Substitute dividends arise in short sale or similar transactions when the broker makes an in lieu payment instead of a dividend.\(^8\)

\(^3\) See sections 501 and 521. Section 1(h)(11)(B)(ii)(I).
\(^4\) See section 591. Section 1(h)(11)(ii)(I).
\(^5\) See section 404(k). Section 1(h)(11)(B)(ii)(II).
\(^6\) Section 1(h)(11)(B)(iii).
\(^7\) Section 1(h)(11)(D)(ii). In addition, qualified dividend income does not include any amount which the taxpayer elects to take into account as investment income under section 163(d)(4)(B) to take advantage of the deduction for investment interest.
C. Constructive Dividends.

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

1. Unreasonable Compensation. If the corporation pays a shareholder (or the shareholder’s relative) who is also an employee of the corporation more than reasonable compensation, the excess is treated as a dividend with the consequence that the corporation may not deduct such excess as a business expense. The employee is required to include the full amount in his gross income in any case. Note that the failure of a closely-held corporation to pay dividends is a significant (but not conclusive) factor in determining whether compensation paid to a shareholder-employee is unreasonable.9

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

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

4. Shareholder’s Personal Expenses. Corporate payments of expenses that provide only incidental or no benefit to the corporation may be reclassified as dividends.

5. Payment on Reclassified Debts. If a shareholder’s debt to the corporation is reclassified as equity, corporate payments of interest and principal on such “debt” are treated as dividends.

6. Corporate Low Interest Loans. If the corporation lends money to a shareholder at below market interest rates, the foregone interest is treated as dividends to the shareholder (followed by a deemed payment of the same amount to the corporation as interest).10

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

The amount of the distribution is a dividend to the shareholder to the extent the corporation has sufficient current or accumulated E&P.11 The portion of a distribution amount that is not a dividend (because it exceeds both current and accumulated E&P) is treated as a

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10 Section 7872.
11 Section 316(a); Reg. § 1.316-2(a).
recovery of the shareholder’s capital that reduces his basis in the stock. Any portion of the distribution amount remaining after being treated as a dividend and/or capital recovery, is treated as a gain from a sale or exchange of the shareholder’s stock.12

III. PASS-THROUGH ENTITY OR C CORPORATION?

A. **In General.**

The determination of whether to use a pass-through entity, such as an S corporation, a partnership, or a limited liability company, rather than a C Corporation to operate a business, a line of business, or an investment activity, may depend on many considerations, including the stage of the life cycle of the business or investment.

1. The pass-through entity may be advantageous during the startup phase when losses may be generated, since the losses may be passed through to the owners.

2. When the corporation must retain its earnings to fund growth and operation of the business, pre-2003 Act lower C corporation rates were often considered preferable to higher individual rates. This is not necessarily true for 2003 through 2008.

3. When the business entity becomes highly profitable and it is desirable to distribute earnings to the owners, pass-through entity status will generally be preferable.

4. When the owners desire to sell the business, the pass-through entity will be preferable because of the single level of tax incurred by the owner (generally at the capital gain rate) upon the sale of the business or its assets.

Unfortunately, conversion from pass-through to non-pass-through status and back (i.e. S to C to S) during the different stages of the business life cycle may be cost-prohibitive and impractical. A taxable liquidation of a corporation to obtain partnership tax treatment (i.e., conversion of corporation to an LLC) will trigger multiple levels of tax. Conversion from C to S status may result in the triggering of the LIFO recapture tax imposed by section 1363(d), imposition of the built-in gains tax under section 1374, the loss of NOL carryovers under section 1371(b), and the 5-year limitation on election after termination under section 1362(g). The tax on excess passive income under section 1375 and the less favorable distribution rules for S corporations with accumulated E&P may also come into play.

The decision as to what type of pass-through entity to use may depend upon business, state law and other non-tax considerations, as well as the extent to which the flexibility afforded to partnerships and LLCs (when compared to S corporations) is of any significance to the business owners. The present ownership and operation of the business by a C corporation may limit the choice to that of a tax-free conversion from C to S as opposed to a taxable liquidation or other restructure of the operations in order to form a partnership or LLC for the benefits of a pass-through entity.

B. **Advantages of Operating as a Pass-Through Entity.**

There are a number of advantages of operating a business as a pass-through entity:

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12 Section 301(c)(3).
1. One Level of Tax on Earnings with Increase in Owner Basis for Undistributed Earnings.

The earnings of a pass-through entity are generally subject to only one level of tax at the owner level. In contrast, the earnings of C corporations are subject to a level of tax at the corporate level as well as at the shareholder level, when earnings are distributed to the shareholders as dividends. Accordingly, the maximum combined corporate and individual marginal rate for earnings distributed to shareholders of a C corporation will be higher than the rate imposed on the owners of a pass-through entity.

If earnings are not distributed currently, an S corporation shareholder’s basis in S corporation stock or a partner’s basis in a partnership interest is increased by the shareholder’s or partner’s proportionate share of the undistributed income of the S corporation. As a result, future distributions will be treated as a return of capital (except to the extent attributable to the corporation’s E&P when it was a C corporation). If earnings are continuously accumulated, the shareholder’s or partner’s basis will increase, resulting in less gain upon sale of the stock or liquidation of the business.

In contrast, a C corporation shareholder’s basis in stock is not increased by the earnings taxed at the corporate level with the result that all of the gain (sales proceeds less original basis) is subject to capital gains tax upon the sale of the stock.

2. Avoidance of Double Tax Upon Sale or Liquidation of Business.

Except for the ten-year recognition period for the built in gains tax after conversion of a C corporation to S status, shareholders of an S corporation or partners of a partnership are effectively subject to only one level of tax upon the sale of the business and assets of the corporation or upon the liquidation of the corporation. This makes the S election particularly attractive for corporations that expect the value of the business to appreciate substantially or which will hold appreciating assets or property.

C corporations and C corporation shareholders, on the other hand, are subject to a double tax on the sale of the corporation’s assets or upon liquidation. If the gain is taxed at the corporate level at the rate of 35% and the net distribution is taxed at the shareholder level at a 15% rate, the effective (corporate and individual) marginal tax rate for such a sale or liquidation by a C corporation is 44.75%.

Accordingly, the S corporation is generally superior to the C corporation if the scenario may involve the sale of a business that has appreciated substantially in value. When the corporation’s business is not expected to appreciate substantially in value (for example, in the case of a personal service business where the business is dependent upon the personal involvement of the individual owners — e.g., legal, accounting and many health care businesses), the shareholders may desire to hold property with the potential to appreciate in a separate pass-through entity (for example, a general or limited partnership or an LLC).

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13 For reference purposes, members of an LLC classified as a partnership for tax purposes are sometimes referred to in this article as partners in a partnership, and a membership interest in an LLC is sometimes referred to as a partnership interest. It is further assumed, unless indicated otherwise, that an LLC will not elect to be classified as an association taxable as a corporation under Reg. §301.7701-3(c)(1)(i).
partnership or LLC may lease the real property to the C corporation and maintain the opportunity for a single level of tax upon the sale of the property. 14


The net loss of a pass-through entity is passed-through and taken into account by the owners in proportion to their ownership. For example, an S corporation shareholder or partner in a partnership may use his pro rata share of losses to offset other income, subject to the following loss limitations:

a. The shareholder or partner must have sufficient basis in his S corporation stock or debt or partnership interest to deduct the pro rata share of the losses.

b. The shareholder or partner must have sufficient amounts “at-risk” to deduct losses under the at-risk limitation rules of section 465, if applicable.

c. The shareholder’s or partner’s pro rata share of losses may be subject to the passive activity loss limitation rules of section 469.

On the other hand, losses of a C corporation do not pass-through to shareholders, but are allowable as deductions only against future taxable income of the C corporation under the NOL carryover rules of section 172. Accordingly, when it is anticipated that a start-up business will incur initial losses, and the shareholders have other income that could be offset by such losses, it may be advantageous for the business to be operated as a pass-through entity rather than a C corporation.


a. Wages and Salaries Subject to FICA Tax. Many closely-held businesses are operated so as to effectively avoid the double tax on corporate earnings by distributing substantial salaries to the owners who are also employees. Assuming such salaries are reasonable compensation, they will be deductible by a C corporation and result in only a single level of tax to the owners. An S corporation is not subject to the same pressure to pay deductibility to shareholders. Partnerships and limited liability companies do not pay salaries to partners and members, but guaranteed payment and partnership allocations to service providers are subject to self-employment tax (“SECA tax”).

Salaries will be exempt from the old age, survivor, and disability insurance (“OASDI”) portion of the Federal Insurance Contribution Act (“FICA”) tax on both the employer and the employee to the extent in excess of the prescribed maximum wage base. The OASDI tax rate is 6.2% on both the employer and the employee on the first $87,900 of annual wages in 2004.

14 Sales taxes or gross receipt taxes may be imposed upon lease payments made by the C corporation to the partnership or LLC. If the property is expected to produce losses, deductibility of such losses may be limited by the basis limitations, the at-risk limitation rules, or the passive activity loss rules. Lease payments made by the C corporation to the partnership or LLC under common control may be subject to scrutiny if not set at a fair market rental amount.
However, RRA ‘93 removed the wage limitation on the Medicare hospital insurance ("HI") portion of the FICA tax, resulting in an HI tax rate of 1.45% on both the employer and the employee (total of 2.9%) with respect to all wage payments. Self-employment taxes are imposed at a rate equal to the total rate for the employer and employee shares of employment taxes (12.4% OASDI tax rate and 2.9% HI tax rate for a total of 15.3%). As in the case of employment taxes, the HI portion of the SECA tax is not limited and applies to all self-employment earnings.

b. When Lower Salaries are Advantageous. In some cases, it may be preferable for an S corporation to pay lower salaries and permit the distribution of earnings as S corporation distributions in order to avoid the HI tax on the additional wage payments. Unlike a partnership, where a general partner’s distributive share of the income of any trade or business carried on by the partnership generally constitutes net earnings from self-employment subject to the tax on self-employment income, dividends are excluded from the definition of net earnings from self-employment. In addition, the IRS found in Rev. Rul. 59-221, that an S corporation’s income does not constitute net earnings from self-employment for purposes of the tax on self-employment income.

Consideration should be given to the payment of reasonable compensation in order to avoid the recharacterization of S corporation distributions as wages, as in Rev. Rul. 74-44, where two shareholders of an S corporation drew no salary. Since the arrangement was found to be made for the express purpose of avoiding the payment of federal employment taxes, the IRS recharacterized the distributions as wages for FICA and FUTA purposes. Similarly, in Radtke v. United States the Court recharacterized distributions made to the sole shareholder-attorney of an S corporation 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 distributions and received no salary from the S corporation during the taxable year.

Absent these abusive facts, the IRS may have difficulty asserting that distributions made by an S corporation to shareholder-employees who are otherwise paid reasonable salaries should be characterized as additional wages subject to Social Security taxes.

c. Self-Employment Tax Considerations for Partnerships and LLCs. Section 1402(a) provides that an individual’s distributive share of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member is included in the definition of net earnings from self-employment. However, the distributive share of a “limited partner” (other than section 707(c) guaranteed payments to the partner as

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15 Section 1402(a)(2); cf. Durando v. United States, 70 F.3d 548, 76 A.F.T.R.2d (P-H) 7464 (9th Cir. 1995) (S corporation shareholder’s distributive share cannot be treated as net earnings from self-employment for purposes of computing Keogh plan deductions).

16 1959-1 C.B. 225.

17 See also Ding v. Commissioner, T.C. Memo 1997-435 (1997), aff’d. 200 F3d 587 (9th Cir. 1999) (pass through items from S corporation not included in computation of shareholders’ self-employment income).

18 1974-1 C.B. 287.

19 895 F.2d 1196 (7th Cir. 1990).

remuneration for services rendered to the partnership) is excluded from this definition under section 1402(a)(13). Historically, state law characterizations were used to distinguish between general and limited partners for this purpose. The rapid evolution of LLCs classified as partnerships led to uncertainty as to how LLC members should be treated for self-employment tax purposes and created a need for further guidance.

Proposed Regulations under section 1402 relating to the application of the limited partner exception to LLC members were first published in the Federal Register in December, 1994, providing that an LLC member is treated as a limited partner if: (1) the member lacked the authority to make management decisions necessary to conduct the LLC's business, and (2) the LLC could have been formed as a limited partnership rather than an LLC in the same jurisdiction, and the member could have qualified as a limited partner in the limited partnership under applicable law.

After considering public comments, the IRS replaced the 1994 regulations with new Proposed Regulations which were published in the Federal Register in January, 1997 defining which partners of a partnership are considered “limited partners” under section 1402(a)(13). Unlike the predecessor provisions, the 1997 Proposed Regulations provide a set of rules applicable to all entities classified as a partnership for federal tax purposes, under which state law characterizations are not determinative.

Generally, an individual is treated as a limited partner under the 1997 Proposed Regulations unless the individual (1) was personally liable for debts of or claims against the partnership by being a partner; (2) has authority to contract on behalf of the partnership under applicable state law; or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. The 1997 Proposed Regulations further provide that an individual holding more than one class of interest who does not qualify as a limited partner under the general rules above can bifurcate his interest in the LLC and still be treated as a limited partner with respect to a specific class of interest in certain situations. Another exception allows certain individuals holding only one class of interest who fail to satisfy the general definition of limited partner solely because of the 500 hour participation limit to qualify as limited partners. In any case, however, an individual who is a service partner in a professional service partnership will never be treated as a limited partner under section 1402(a)(13) regardless of whether the rules above are otherwise satisfied.

The 1997 Proposed Regulations drew much criticism, in large part because most LLC managers would be subject to self-employment tax on their distributive share of LLC income since they normally have the authority to contract on behalf of the LLC. Also, the 1997 Proposed Regulations created the possibility that an individual characterized as a limited partner under state law would not be treated as a limited partner under section 1402(a)(13) because of the 500 hour participation limit.

As a result of harsh criticism of the 1997 Proposed Regulations and concern that the IRS had exceeded its regulatory authority, the Taxpayer Relief Act of 1997 ("TRA '97") imposed a moratorium on the issuance of temporary or final regulations with respect to the definition of a limited partner under section 1402(a)(13) before July 1, 1998. The legislative history reveals
the Senate's view that the IRS should withdraw the 1997 Proposed Regulations defining limited partner for self-employment tax purposes and that Congress should address this issue. The IRS has not issued any additional guidance under section 1402(a)(13) with respect to the definition of a limited partner.

In the absence of regulatory guidance, taxpayers may take a position with respect to whether an individual's share of income is self-employment income based upon the statutory limited partner exception and all of the facts and circumstances. Reliance on the 1997 proposed regulations should be justified. Small business advocates, the American Bar Association Section of Taxation, and the tax division of the American Institute of Certified Public Accounts have urged Congress to act and revamp section 1402(a)(13). These advocates have urged that returns on capital should be free of self-employment tax and that only "reasonable compensation" should be subject to self-employment tax.\textsuperscript{23}

5. Avoidance of Accumulated Earnings Tax Imposed on C Corporations.

A corporation that accumulates earnings beyond the reasonable needs of the business in order to take advantage of the lower corporate tax rates may be vulnerable to the accumulated earnings tax of section 531. The accumulated earnings tax applies to every corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders by permitting E&P to accumulate instead of being distributed as dividends.

A pass-through entity is not subject to the accumulated earnings tax.\textsuperscript{24} A business operated as an S corporation will therefore have no vulnerability to the section 531 tax.

6. Avoidance of PHC Tax.

Section 541 imposes a tax on the undistributed PHC income, as defined in section 545, of every PHC, as defined in section 542. PHC 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.\textsuperscript{25}

A pass through entity such as a S corporation or an LLC is not subject to the PHC tax.\textsuperscript{26} Accordingly, a business which may be subject to the PHC tax may be operated as an S corporation and eliminate PHC tax exposure. However, an S corporation with E&P from its C corporation years will be subject to the corporate level tax on excess passive investment income and will be subject to termination of the S election under section 1362(d)(3).

7. Deductibility of Interest on Debt Incurred to Purchase Interests in a Pass-Through Entity.

Investment interest deductions are limited for individuals to the extent of their investment income under section 163(d). Investment income does not include net capital gains from the

\textsuperscript{24} Section 1363(a).
\textsuperscript{25} Section 543.
\textsuperscript{26} Section 1363(a).
disposition of investment property, unless the taxpayer elects under section 163(d)(4)(B) to treat net capital gains as investment income, thereby foregoing the preferential rate applicable to long-term capital gains.

When a shareholder borrows to purchase stock in a C corporation, it is likely that the interest expense associated with the debt will be subject to the section 163(d) investment interest limitation. In order to avoid the investment interest limitation rules, the C corporation shareholder must show that he had no "substantial investment motive". For example, a shareholder-employee would have to show that he purchased the stock to protect his status as an employee rather than to pursue an investment motive as a shareholder.

The proceeds of debt incurred to purchase stock in an S corporation or partnership interest in a partnership or membership interest in an LLC and the related interest expenses are allocated among the assets of the pass-through entity under Temp. Reg. § 1.163-8T using any reasonable method. To the extent that the assets of a pass-through entity are assets used in its trade or business, the interest expense on debt incurred to an interest in the entity and allocated to such trade or business assets will be fully deductible as trade or business interest, and will not be subject to the investment interest limitation of section 163(d). To the extent that the assets of the pass-through entity constitute investment assets, the interest expense on debt incurred to purchase the interest and allocated to such investments will be subject to the section 163(d) investment interest limitations.

In a leveraged acquisition of a corporation or start-up, the operation of the business as a pass-through entity, likely an S corporation, may make it possible for the owners to deduct the interest paid by them on debt incurred to purchase the business or capitalize the venture.

8. Avoidance of Limitations on Using Cash Method of Accounting.

Section 448 provides that C corporations may not compute their taxable income under the cash method of accounting, unless they qualify as certain farming corporations, qualified personal service corporations, or other corporations having average annual gross receipts of $5 million or less. S corporations, on the other hand, may generally use any method of accounting, unless the S corporation is a "tax shelter" within the meaning of section 461(i)(3).

Many businesses may prefer to control the timing of income and deductions through the cash method of accounting. The S corporation’s ability to use a cash method over the limitations on a C corporation may be a significant advantage to many businesses.


The income tax rates described in this article do not take into consideration state taxes on corporations and individuals. Most states recognize the S election for state income tax purposes, so that the decision to elect S status has no impact on state tax liabilities.

Some states, such as Florida, do not have an individual income tax and impose no tax on S corporation income (except for built-in gains and excess passive investment income if taxed

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28 Section 448(a)(3).
under sections 1374 or 1375). By imposing corporate level taxes on C corporations, these states create a distinct advantage for the S corporation. Other states, such as California, impose an entity level tax on S corporation income.

C. Disadvantages of Operating as a Pass-through Entity.

There are several disadvantages that must be considered in making an S election or selecting a partnership or limited liability company as the choice of business entity.

1. No Benefit of Lower Corporate Rates.

While the differential between the maximum marginal corporate rate induced many corporations to make the S election prior to the enactment of RRA '93, the differential between the 35% maximum corporate rate and the 38.6% maximum individual rate under EGTRRA-2001 often made it advantageous to operate as a C corporation. The advantage disappeared when some or all of the earnings were to be distributed to the shareholders and subjected to both the corporate level and individual level tax. As discussed above, the corporate rate differential is diminished further for 2003 through 2010 by the 2003 Act. There is still a lower tax rate for corporate income up to $75,000 if reinvested in the business and not distributed to shareholders.

The predictability of the corporate income, the need to reinvest earnings in the business, the availability of cash for distributions to shareholders to pay shareholder level taxes, sources of other income of the shareholders, and the possibility of future changes in tax rates must be considered in all cases.

2. Tax Costs of Converting from C to S.

An existing C corporation may incur tax costs in converting from C to S status, in light of the LIFO recapture tax imposed by section 1363(d), the built-in gains tax under section 1374, the loss of NOL carryovers under section 1371(b), and in some cases, the tax on excess passive income under section 1375. In addition, conversion of an existing C corporation can result in a "bunching" of income if the C corporation has been using a fiscal year other than a taxable year permitted to an S corporation under section 1378.

3. Limitations on Filing Consolidated Returns.

Prior to the '96 Act, an S corporation could not hold 80% or more of the outstanding stock of another corporation, and could not have a corporation as a shareholder. Therefore, it was necessary to use the C corporation when it was desirable to operate several businesses in separate corporations or to operate separate subsidiaries in several states. By filing a consolidated return, the taxable income of profitable businesses in the affiliated group could be offset by the losses of unprofitable businesses. This result was difficult to obtain through multiple brother-sister S corporations, unless all of the shareholders materially participate in the activities of each S corporation or otherwise satisfied the passive loss limitations and each shareholder had sufficient basis to permit the pass-through of losses. For taxable years beginning after December 31, 1996, an S corporation may hold C or S subsidiaries. While the S corporation parent is not permitted to join with corporate subsidiary or subsidiaries in filing a
consolidated return, it can hold partnership interests and membership interests in LLCs, including single member LLCs treated as disregarded entities, and obtain multi-level pass-through treatment.

4. Section 1202 Exclusion Not Available.

Section 1202 provides for a 50% exclusion from the gain on the sale of qualified small business stock held for more than five years, subject to certain limitations. Since section 1202 only applies to the stock of C corporations, shareholders of S corporations may not take advantage of this exclusion.\(^\text{30}\)

The section 1202 exclusion applies to the sale of stock but not to the sale of the corporation’s assets. Since buyers may be less willing to purchase stock as a result of the existence of potential unknown and contingent liabilities of the seller, substantially less may be realized for the sale of stock, as compared with the sale of the assets by a pass-through entity with only a single level of tax.

5. Loss of Tax-Free Employee Fringe Benefits.

A 2-percent shareholder of an S corporation is treated as a partner of a partnership for purposes of qualifying for tax-free employee fringe benefits. As a result, a 2-percent shareholder or a partner may not exclude from income the value of corporate provided health and accident insurance, disability insurance, group term life insurance, cafeteria plan benefits, or the value of meals and lodging furnished for the convenience of the employer.

Accident and health insurance premiums paid for the benefit of the 2-percent shareholder are treated the same as guaranteed payments to a partner under section 707(c), deductible by the S corporation under section 162 and includible in the recipient’s gross income under section 61.\(^\text{31}\)

6. Limitation on Selection of Taxable Year.

An S corporation must have a “permitted taxable year” under section 1378, which includes a calendar year, a fiscal year permitted pursuant to an election under section 444 (resulting in a deferral of not more than three months and subject to annual deposits by the corporation for approximately the same amount as the shareholders would have paid if the corporation were on a calendar year), or a fiscal year for which the corporation establishes a sufficient business purpose.

On the other hand, a C corporation may generally choose any fiscal year. A personal service corporation operating as a C corporation must maintain a calendar year unless it establishes a business purpose for a different year or elects a fiscal year under section 444 (providing for a year not resulting in a deferral of greater than three months and compliance with the requirements of section 280H with respect to the deduction of compensation paid to employee-owners).

\(^{30}\) See section 1202(c)(1).

7. Restrictive Eligibility Requirements for S Corporation Status.

In any case where the eligibility requirements for an S corporation cannot be satisfied (i.e., single class of stock), or require a different approach to the structure of the business, the C corporation may provide more options for structuring arrangements among the owners. The '96 Act relaxes many of the restrictions and requirements for an S corporation, including the increase of the numerical shareholder limitation to 75, permitting sprinkle trusts as shareholders, and permitting C and S subsidiaries, effective for taxable years beginning after December 31, 1996.

D. Advantages of Operating as a C Corporation.

There are several distinct advantages of operating a business as a C corporation.

1. Multiple Classes of Stock; No Limitations on Shareholders.

Unlike S corporations, a C corporation may issue more than one class of stock, including preferred stock. The limitations on the number and types of shareholders in an S corporation do not apply to a C corporation.

2. 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 individual 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.


Section 1202 permits individual shareholders to exclude from gross income 50% of gains realized 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).

4. No Shareholder-Level Tax on Undistributed Income.

Unlike owners of businesses operated as partnerships, S corporations and limited liability companies that have elected partnership tax treatment, shareholders of a C corporation are not taxed on the undistributed income of the corporation. Thus, in the case of a small businesses (other than professional service businesses) that would be subject to lower corporate rate brackets of 15% and 25% under section 11 and plans to reinvest earnings in the business rather than distribute earnings to the shareholders, the C corporation might be the preferred choice.

5. Fringe Benefits.

The cost of health insurance and other fringe benefits (e.g., group health, disability and accidental insurance) provided by a C corporation to its shareholder employees is deductible by
the corporation and excluded from the shareholder employees' income.\footnote{32} In contrast, S corporation shareholder employees who own more than 2 percent of the stock must include the amount of medical insurance premiums paid by the corporation in their gross income.\footnote{33}

6. 

**Taxable Year.**

C corporations may adopt a taxable year without regard to the taxable year of the shareholders.\footnote{34}

7. 

**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.

E. 

**Disadvantages of Operating as a C Corporation.**

There are distinct disadvantages of operating a business as a C corporation.

1. 

**Entity Level Tax/Double Taxation.**

The net income of a C corporation is subject to taxation at the corporate level.\footnote{35} Dividends distributed to shareholders are taxed to the shareholders (albeit at a 15% rate under the 2003 Act), with no corresponding deduction to the corporation, resulting in the “double taxation” of corporate income that is distributed to the shareholders. Attempts to avoid shareholder-level taxes by not making distributions might subject the corporation to the “accumulated earnings tax,” discussed below.

In addition, where assets are distributed to the shareholders: (a) any gain inherent in the assets is recognized by the corporation on the distribution; and (b) losses inherent in distributed assets may be recognized only in a liquidating distribution, subject to some limitations.\footnote{36}
2. Corporate Losses.

Corporate losses cannot be deducted by the shareholders. Contrast with entity-level losses that generally can be deducted by owners of S corporations, partnerships and limited liability companies.


A C corporation must, as a general rule, use the accrual method of accounting, which could result in corporate-level taxes even in the absence of actual receipt of income.\textsuperscript{37} C corporations with annual gross receipts of $5 million or less and qualified personal service corporations are exempt from the general rule.\textsuperscript{38}


The corporate alternative minimum tax ("AMT") is a separate and independent tax that is parallel to the "regular" corporate income tax.\textsuperscript{39} 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.

The tax is imposed, at a rate of 20\%, on alternative minimum taxable income ("AMTI"), but only to the extent AMTI exceeds an exemption amount of $40,000 reduced by 25\% of the amount by which AMTI exceeds $150,000.\textsuperscript{40} In general, AMTI is taxable income, subject to a number of special adjustments. Some items, such as depreciation, pollution control facilities, depletion and intangible drilling costs, may be treated differently for AMT than for regular tax. In addition, most corporate taxpayers must include an adjusted current earnings (ACE) adjustment to AMTI. This adjustment increases AMTI for items excluded from regular tax such as tax-exempt interest, certain dividends received deductions, the difference between LIFO and FIFO inventory and a portion of the deferred gain on installment sales.\textsuperscript{41}

The corporate AMT generates a minimum tax credit for any AMT paid. This credit is used against regular tax (but limited by AMT) where the taxpayer is paying regular tax. Thus, AMT is essentially a prepayment of regular tax. However, it may be years before the prepayment of AMT represented by the minimum tax credit is recoverable.

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.\textsuperscript{42} For the corporation's first three-year period (or portion of a period), the limit is $5 million instead of $7.5 million.\textsuperscript{43}

\textsuperscript{37} Section 448(a)(1).
\textsuperscript{38} Section 448(b)(3), (2).
\textsuperscript{39} Section 55(a).
\textsuperscript{40} Section 55(b)(1)(B), (d)(2), (d)(3)(A).
\textsuperscript{41} See Sections 56 through 58.
\textsuperscript{42} Section 55(e)(1)(A).
\textsuperscript{43} Section 55(e)(1)(B).
5. Accumulated Earnings Tax.

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.\textsuperscript{44}

The accumulated earnings tax normally applies to the accumulated taxable income at the highest tax rate imposed on single filers, but the 2003 Act has reduced that rate to 15\% for tax years beginning after December 31, 2002 and before January 1, 2009. Accumulated taxable income is the corporation's taxable income, subject to certain adjustments,\textsuperscript{45} reduced by: the dividends-paid deduction, if any, and the accumulated earnings credit.\textsuperscript{46} The accumulated earnings credit is an amount that starts at $250,000 but could be higher if justified by the reasonable business needs of the corporation.\textsuperscript{47} In other words, the accumulated earnings credit is designed to allow corporations to retain at least $250,000 and as much of earnings as is supported by the reasonable needs of the business.\textsuperscript{48}

6. Personal Holding Company Tax.

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. The tax normally applies at the highest tax rate imposed on single filers, but the 2003 Act has reduced that rate to 15\% for tax years beginning after December 31, 2002 and before January 1, 2009.

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.\textsuperscript{49}

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.\textsuperscript{50} 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).\textsuperscript{51} Adjustments to taxable income

\textsuperscript{44} Section 531.
\textsuperscript{45} The adjustments, as provided in section 535(b), include: (A) income taxes accrued to the corporation for the year; (B) corporate charitable contributions over the 10\% deduction limit under section 170(b)(i); (C) the corporation's capital losses disallowed under section 1211; and (D) the corporation's net capital gain for the year.
\textsuperscript{46} Section 531(a).
\textsuperscript{47} Corporations performing services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting may claim a minimum accumulated earnings credit of only the excess of $150,000 over accumulated earnings at the end of the preceding tax year.
\textsuperscript{48} Section 535(c).
\textsuperscript{49} Section 542(a).
\textsuperscript{50} Section 543(a).
\textsuperscript{51} Section 545(a).
generally include negative adjustments for federal income taxes, certain net operating losses, and net capital gains less the attributable taxes.

IV. WHEN IS THERE AN ENTITY OF CHOICE?

A. When the C Corporation is the Entity of Choice.

All things considered, there are several cases where the exigencies of the business and the objectives of the owners make the C corporation more attractive than a pass-through entity.

1. Use of Lower Tax Rates.

Small businesses may benefit from the lower marginal tax rates on corporate income (i.e., 15% up to $50,000 and 25% from $50,000 to $75,000). However, the effect of taxation at both the corporate and shareholder levels when the earnings are distributed or the business is sold must be closely scrutinized. Small businesses will generally attempt to avoid the 34% rate imposed on income from $75,000 to $100,000, the 39% rate that applies from $100,000 to $335,000, the 34% rate on income from $335,000 to $10 million, and, of course, the 35% rate imposed on income in excess of $10 million.

2. Consolidated Return for Parent Subsidiary Corporations.

The C corporation has historically been considered to be the proper 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 limited liability companies 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 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.


Since the C corporation can provide many tax deductible and tax free fringe benefits to employees, which are not available to partners of a partnership or 2% shareholders of an S corporation, the C corporation will be the entity of choice for the employee-owners who desire to obtain the tax benefits available to employees as a result of statutory exclusions from gross income. Many professional service corporations will elect to be taxed as a C corporation (rather than as an S corporation, a partnership, or an LLC) for this reason.

B. When the LLC is the Entity of Choice.

There are a number of fact patterns where the limited liability company is the preferred choice of entity. Some of these situations are described below.

1. To Hold Real Property.

LLCs are ideally suited for holding real property for a number of reasons.

**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, many real estate development 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.

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

**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.
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.

Avoiding Limitations on Type and Number of Owners; Special Allocations; Basis for Entity Level Debt. The S corporation avoids the double taxation problem discussed above but has other disadvantages 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.

2. Estate Planning.

A family LLC may be used in the same manner as a family limited partnership as an estate planning technique, again with the added benefit of personal liability protection for all the members of the LLC which would not be available to general partners. A family LLC may be an attractive family business and estate planning technique in many situations, including the management of investments and efficient gift and wealth transfer planning.

Provided the insured is not deemed to have any “incidents of ownership” in a life insurance policy, the insurance proceeds payable to an irrevocable insurance trust upon the death of the insured will not be included in the insured’s taxable estate. The family LLC and family limited partnership can also be used to hold a life insurance policy so that substantially all of the proceeds upon death will not be included in the insured’s estate. The decedent insured’s percentage interest in the LLC or partnership will result in the inclusion of such percentage of the proceeds of the life insurance policy in the decedent’s estate.52

While the irrevocable life insurance trust is by its terms irrevocable and may not be amended by the grantor, the operating agreement of an LLC is contractual in nature and may be amended by its members in accordance with the procedures set forth in the operating agreement without causing the insurance proceeds to be included in the estate of the member-insured.

An LLC that holds an insurance policy insuring the life of a member will not recognize any income as a result of the receipt of insurance proceeds upon the insured’s death regardless of whether the policy is purchased by the LLC or transferred to the LLC by the insured. Generally, life insurance proceeds are not taxable.53 However, if the policy is transferred for valuable consideration, the proceeds will be taxable to the extent that the proceeds exceed the

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52 Regs. § 20.2042-1(c)(6).
53 Section 101(a)(1).
consideration paid plus premiums subsequently paid by the transferee.\textsuperscript{54} This “transfer for value” exception will not apply, and therefore the proceeds will not be taxable, if the policy is transferred to a partner of the insured or to a partnership in which the insured is a partner.\textsuperscript{55} This “exception to the exception” should also apply in the case of a transfer of a policy to an LLC in which the insured is a member.

A portion of the proceeds of a life insurance policy held by an LLC will indirectly be included in the insured member’s estate. The LLC’s receipt of insurance proceeds will create an increase in value of the insured member’s membership interest based on the insured member’s proportionate ownership interest in the LLC.

3. For Venture Capital Projects and Corporate Joint Ventures.

The LLC is an attractive entity for venture capital investors who want control over the businesses in which they invest as well as limited liability protection and pass-through taxation.

\textit{Restrictions on S Corporation.} The S corporation is often too restrictive for venture capital investments because of the second class of stock limitations and the limitation on eligible or permitted shareholders. Preferred returns and special allocations which are common to venture capital deals may not be used in an S corporation structure without risk of violating the second class of stock limitation, but such features are often used in LLCs and partnerships. S corporations also may not have other corporations or partnerships as shareholders, but no such ownership restrictions exist for LLC’s. In addition, because of the degree of control over the management of a business that a venture capitalist may desire, the LLC will often be preferred over a limited partnership, since the venture capital investor cannot participate in the control of a business as a limited partner without forfeiting the protection of limited liability.

\textit{As Joint Venture Between Two Corporations.} The LLC is also an attractive way to structure a joint venture between two corporations. An LLC will allow the corporate joint venturers to have a joint venture structure that will insulate the joint venturers’ assets from the liabilities of the joint venture in a form that permits pass-through taxation. A joint venture in the form of a corporation will not allow pass-through taxation since an S corporation cannot have a corporation as a shareholder, and a joint venture in the form of a partnership will expose the general partners to the liabilities of the partnership.

\textit{In Lieu of Corporate Subsidiaries.} A single member LLC (treated as a “disregarded entity”), if authorized under applicable state law, may be an effective substitute for wholly-owned subsidiaries of C and S corporations, as well as other LLCs and partnerships.

4. For the Professional Service Business.

Since 1969, certain types of professionals have been able to form professional corporations through which to conduct their practices in most states. Many states permit professionals to form professional limited liability companies (“PLLC”) through which the professionals may render professional services. The limitation on personal liability of a member of a PLLC for errors, omissions, negligence, incompetence, or malfeasance of another member

\textsuperscript{54} Section 101(a)(2).
\textsuperscript{55} Section 101(a)(2)(B).
or representative of his firm not under his supervision or control is generally the same as that of a shareholder of a professional corporation. With respect to contract and other non-tort type liabilities of the PLLC, a member will not be personally liable for such obligations unless he personally guarantees an obligation or otherwise becomes personally liable by reason of his own acts or conduct. In some states, a PLLC must register as such with the applicable state licensing board pursuant to regulations adopted by such board before it will be permitted by the Secretary of State to file its articles of organization as a PLLC.

Many states now allow a partnership to register as a “registered limited liability partnership” (“LLP”). Under the applicable state statute, the limitation on personal liability of a partner of an LLP is generally similar to that of a member of a PLLC and a shareholder of a professional corporation.

C. When the S Corporation is the Entity of Choice.

The number of corporation and partnership tax returns filed annually show that S corporations filing Form 1120S are still more popular than C corporations (Form 1120) and partnerships and LLCs (Form 1065). S corporations are obviously familiar to accountants and attractive because of their administrative simplicity. There are several situations where the S corporation is the clear entity of choice.

1. Already an S Corporation

Many corporations converted from C to S after TRA ‘86 in order to avoid the double tax and take advantage of lower individual tax rates. In light of the costs of liquidating or distributing assets from the corporation, these businesses will likely continue to operate as S corporations rather than convert to a partnership or LLC structure.

2. Existing C Corporation Desiring to Convert to Pass-through Entity.

There is no tax cost of converting a C corporation to S unless assets are disposed of during the 10 year recognition period for the built-in gains tax. Accordingly, a C corporation desiring to operate as a pass-through entity will generally elect S corporation status rather than liquidate and distribute assets to shareholders for purposes of the formation of a partnership or LLC to continue its business.


An S corporation can participate in tax free reorganizations, spin-offs, or split-ups, and participate in qualified stock purchase transactions under section 338 while enjoying the advantages of treatment as a pass-through entity. Partnerships and LLCs would have to be incorporated in order to take advantage of these tax advantaged provisions of the Code.

D. Summary of Choice of Entity Considerations

In making the decision as to form of entity, a choice should initially be made based upon whether a pass though entity is desired. If a pass though entity is not desired, the C corporation is the entity of choice. If pass-through treatment is desired and liability limitation is important,
the choice is narrowed to either an LLC or an S corporation. If liability limitation is not important (where for example, the activity is passive and no significant risk of liability attaches), then the pass-through entity to be chosen would likely be a partnership.

For most small and closely held businesses, the LLC or the S corporation will continue to be the preferred choice after the 2003 Act. The avoidance of the entity level tax and the pass-through of the character of income as ordinary, capital gain, dividends, or tax exempt income, or the availability of losses to offset income from other sources, will prove advantageous in most cases. These considerations will be even greater if (or when) the owners decide to sell the business, since there will be no corporate level tax and the proceeds of sale will generally qualify for capital gains treatment at the member or shareholder level.

V. DISREGARDED ENTITIES—AN OVERVIEW

A business entity that is not classified as a corporation under regulation §301.7701-2(b) (an “eligible entity”) can elect its classification for federal tax purposes. An eligible entity with two or more members can elect to be taxed as a corporation or as a partnership. Unless an election is made to be taxed as a corporation, the entity will be treated as a partnership.

An eligible entity with a single member can also elect to be taxed as a corporation or to be disregarded as an entity separate from its owner. Unless an election to be taxed as a corporation is made, the entity will be treated as a disregarded entity. If the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner.\(^{57}\)

If an eligible entity is wholly owned by a husband and wife as community property, the owners may elect to treat the entity as disregarded or as a partnership.\(^{58}\) If the entity is not owned as community property it will be treated as a partnership.

An eligible entity may elect to be treated as a corporation by filing Form 8832.\(^{59}\) Temporary regulations offer a streamlined procedure where an eligible entity whose default classification is a partnership or a disregarded entity wishes to be classified as an S corporation.\(^{60}\) Generally this would be accomplished in two steps. First, the entity would file Form 8832 to be classified as an association taxable as a corporation\(^{61}\) and, second, the entity would file Form 2553 to elect S status. The temporary regulations permit the eligible entity simply to file Form 2553 assuming the S election is available to the entity and assuming the Form 2553 is filed in a timely manner. The Service makes clear that if an eligible entity has elected to be treated as a corporation, a sale of all of the interests in the eligible entity does not terminate the election.\(^{62}\)

An eligible entity classified as a partnership becomes disregarded as an entity separate

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\(^{56}\) Reg. §301.7701-3.
\(^{57}\) Reg. §301.7701-2(a).
\(^{59}\) Reg. §301.7701-3(c). See also Temp. Reg. §301.7701-3T, where the eligible entity desires S corporation status.
\(^{60}\) Temp. Reg. §301.7701-3T.
\(^{61}\) See Reg. §301.7701-3(c)(1)(i).
from its owner when the entity’s membership is reduced to one member. A single member entity disregarded as an entity separate from its owner is reclassified as a partnership when the entity has more than one member.

A “qualified subchapter S subsidiary” (a “QSUB”) is treated as a disregarded entity. To be a QSUB, a corporation must be 100% owned by an S corporation and the S corporation must properly elect to treat the subsidiary corporation as a QSUB. A QSUB is not treated as a separate corporation for federal tax purposes. All assets, liabilities and items of income, deduction and credit of the QSUB are treated as those of the S corporation parent.

A “qualified REIT subsidiary” (a “QRS”) is treated as a disregarded entity. To be a QRS, a corporation must be 100% owned by a real estate investment trust (a “REIT”). A QRS is not treated as a separate corporation for federal tax purposes. All assets, liabilities and items of income, deduction and credit of the QRS are treated as those of the REIT. Note that no special QRS election is required (unlike a QSUB). Rather, a wholly owned corporate subsidiary of a REIT will be treated as a QRS if an election is not made to treat the subsidiary as a “taxable REIT subsidiary.”

In Rev. Rul. 2004-77, the Service considered the proper tax treatment of a limited partnership (“LP”). The 99% limited partner of LP was Smith. The 1% general partner of LP was Smith LLC, which was wholly owned by Smith and a disregarded entity. Even though LP is a limited partnership for state law purposes, it is a disregarded entity for tax purposes because it is 100% owned by Smith for tax purposes and no election was made to treat LP as a corporation.

VI. CONVERSION FROM DISREGARDED ENTITY STATUS TO PARTNERSHIP OR CORPORATION STATUS

A. From Single Member Eligible Entity to Partnership

A single member eligible entity disregarded as an entity separate from its owner is reclassified as a partnership when the entity has more than one member. In Rev. Rul. 99-5, the Service considers two fact patterns where a single member LLC that is disregarded converts to an entity taxable as a partnership by virtue of the addition of a second member.

In Situation 1, A owns 100% of LLC. B purchases a 50% interest in LLC from A for $5,000. A pockets the money. B’s purchase is treated as the purchase by B, and as the sale by A, of a 50% undivided interest in the LLC’s assets followed by a deemed contribution by A and B of their undivided interests in the assets to LLC. A recognizes gain or loss on the sale to B. A does not recognize gain or loss on the deemed contribution of his remaining 50% undivided interest to LLC. A’s basis in his interest in LLC is equal to his basis in the 50% undivided interest.
interest in the assets.\textsuperscript{71} A’s holding period for his interest in LLC includes his holding period in the capital assets and 1231 property owned by LLC at the time of conversion.\textsuperscript{72} B’s basis in his interest in LLC reflects the $5,000 purchase price paid for the 50% interest in LLC. LLC’s basis in its assets reflects the basis of A and B in the LLC assets deemed contributed to LLC at the time of conversion.\textsuperscript{73} LLC’s holding periods for the assets reflects A’s and B’s holding periods in the assets (B’s holding period for his portion of the assets begins on the date of the transaction).\textsuperscript{74}

In Situation 2, B contributes $10,000 to LLC in exchange for a 50% membership interest. The funds stay in LLC. Neither A nor LLC recognizes gain, as this transaction results in a deemed section 721 formation of a partnership.\textsuperscript{75} B’s basis in his LLC interest is $10,000. A’s basis in his LLC interest is equal to the basis in the LLC assets all of which A is deemed to have contributed to the newly formed partnership.\textsuperscript{76} A’s holding period in his LLC interest includes A’s holding period in the capital assets and 1231 property deemed contributed to LLC, and LLC’s holding period for its assets includes A’s holding period.\textsuperscript{77}

B. From QSUB to Corporation

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.\textsuperscript{78} If the parent S corporation transfers a portion of the QSUB’s stock to another person, the subsidiary is no longer eligible for QSUB status. The QSUB is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination in exchange for stock in a transaction analyzed under section 351.\textsuperscript{79}

If the parent S corporation transfers more than 20% of the QSUB stock, section 351 will not apply, thereby triggering gain on the entire transaction (not just the portion attributable to the deemed sale).\textsuperscript{80} The analogous transaction in the case of a single member LLC generates gain only to the extent attributable to the interest sold. To help taxpayers avoid this trap for QSUBs, the Service has volunteered an example in the regulations where a parent S corporation causes a QSUB to merge into a single member LLC (wholly owned by the parent S corporation) with the LLC surviving (the merger of a disregarded entity with another disregarded entity is disregarded).\textsuperscript{81} The parent S corporation then sells 21% of the LLC interests to a third party, triggering only 21% of the gain.

\textsuperscript{71} Section 722.
\textsuperscript{72} Section 1223(1).
\textsuperscript{73} Section 723. Note that A could be subject to the special allocation rules of Section 704(c).
\textsuperscript{74} Section 1223(2).
\textsuperscript{75} Section 721. \textit{But see} Section 721(b) ( contribution to an “investment company” where there is “diversification”).
\textsuperscript{76} Section 722.
\textsuperscript{77} Sections 1223(1) & (2).
\textsuperscript{78} \textit{See} Reg. \$1.1361-5(c).
\textsuperscript{79} Reg. \$1.1361-5(b). Beware of Sections 351(c) & 357(b) and (c).
\textsuperscript{80} Reg. \$1.1361-5(b)(3), Ex. 1. \textit{But see} section 503 of the Subchapter S Modernization Act of 2003 (H.R.2576 and S.1201) (would make sales of QSUB stock the sale of an undivided interest in QSUB assets followed by a section 351 contribution).
\textsuperscript{81} Reg. \$1.1361-5(b)(3), Ex. 2.
What happens if the parent S corporation sells 100% of the stock of a QSUB? The transaction is treated as a sale of assets by the parent S corporation to the purchaser followed by a deemed contribution by the purchaser to a newly formed corporation. If the purchaser is an S corporation and if it makes a QSUB election for its newly acquired subsidiary effective as of the acquisition date, the transaction will be viewed as an asset purchase and sale (and not a stock sale) by purchaser and seller.

Rev. Rul. 2004-85 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 a QSUB or as an S corporation before the expiration of the waiting period under section 1361(b)(3)(D).

If a new stockholder contributes cash or property to the QSUB in exchange for stock of the QSUB, the parent S corporation is treated as transferring the QSUB assets to a newly formed corporation and the new stockholder is treated as transferring the cash or property to the same corporation in the same transaction. Section 351 should apply to prevent gain recognition unless the new corporation is an investment company under section 351(c)(1) and “diversification” results.

C. From QRS to Corporation

If a QRS ceases to meet the requirements to be a QRS, the former QRS will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the REIT in exchange for stock. The deemed transfer of assets to a new corporation may qualify for nonrecognition if the requirements of section 351 are satisfied. For example, if the REIT sells 1% of the stock of a QRS to a third person and the disqualified QRS is not an investment company under section 351(e)(1), the REIT should not recognize gain or loss on the deemed transfer of the QRS assets. If, however, the REIT were to sell more than 20% of the stock of the QRS to a third person, the transaction would be taxable.

VII. CONVERSION FROM PARTNERSHIP OR CORPORATION STATUS TO DISREGARDED ENTITY STATUS

A. From Partnership (LLC) to Disregarded Entity

83 Reg. §1.1361-5(b)(3), Ex. 9.
84 2004-33 I.R.B. 189.
An eligible entity classified as a partnership becomes disregarded as an entity separate from its owner when the entity's membership is reduced to one member. The Service considered the consequences of a conversion from partnership to disregarded entity in Rev. Rul. 99-6. In Situation 1, A and B are equal partners in AB, an LLC. A sells his entire interest in AB to B for $10,000. B causes AB to continue to operate the AB business. In this Situation 1, AB terminates as a partnership under section 708(b)(1)(A). A is treated as selling his LLC interest. B is treated as purchasing a 50% undivided interest in the AB assets. B’s basis in the assets attributable to A’s 50% interest is $10,000 and his holding period for such assets starts on the date immediately following the transaction. Upon termination of AB, B is considered to receive a distribution of the assets attributable to B’s former interest in AB. B may be required to recognize gain under section 731. B’s basis in the assets deemed received by B from AB is determined under section 732(b). B’s holding period for the assets deemed distributed to him from AB includes AB’s holding period.

In Situation 2, C and D are equal partners in CD, an LLC. C and D sell their entire interest in CD to E in exchange for $10,000 cash each. After the sale, the business is continued by the LLC owned solely by E. In this Situation 2, CD terminates as a partnership under section 708(b)(1)(A). C and D report the transaction as a sale of partnership interests. E is deemed to have purchased the CD assets. The technical analysis is that CD is deemed liquidated immediately prior to E’s purchase and the CD assets are deemed distributed to C and D followed by a deemed sale of assets to E.

If, in Situation 1, AB redeems A’s interest for $10,000, AB terminates as a partnership under section 708(b)(1)(A). A should be treated as receiving $10,000 as a distribution in complete liquidation of his interest in AB. A may be required to recognize gain under section 731. B should be treated as having received the remaining assets of AB as a distribution in complete liquidation of his interest in AB. B may be required to recognize gain under section 731. B’s basis in the assets deemed received by B from AB is determined under section 732(b). B’s holding period for the assets deemed distributed to him from AB includes AB’s holding period.

B. From Corporation to QSUB

If an S corporation makes a QSUB election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. The tax treatment will be determined under provisions of the Code applicable to liquidation. Note that typically the S corporation’s basis in the QSUB stock will “evaporate” upon the making of the QSUB election. The basis of the assets in the hands of the QSUB will be the deemed basis in the hands of the S corporation. This could be an issue where the stock of the QSUB was recently purchased by the parent and no section 338(h)(10) election was made.

C. From Corporation to QRS

87 Reg. §301.7701-3(f)(2).
88 1999-1 C.B. 432.
89 Section 735(b).
90 Id.
91 Sections 332 and 337. See section 1374(d)(8) for application of the built in gain rules. See also Reg. §1.1374-8(c) and Prop. Reg. §1.1374-3.
If a REIT acquires all of the stock of an existing corporation and does not elect to treat the corporation as a taxable REIT subsidiary, the corporation will become a QRS and be deemed to have liquidated into the REIT. The tax treatment will be determined under provisions of the Code applicable to liquidation. As in the case of the QSUB, the REIT’s basis in the QRS stock will “evaporate.” The basis of the assets in the hands of the QRS will be the deemed basis in the hands of the REIT. This could be an issue where the stock of the QRS is purchased by the REIT and no section 338(h)(10) election was made.

VIII. DISREGARDED ENTITIES IN CORPORATE REORGANIZATIONS

A. Example 1.

Acquirer, a C corporation, wishes to acquire Target Corp, an S corporation, all of the stock of which is owned by Mary. The parties would like to structure a merger of Target into Acquirer with Mary receiving Acquirer’s stock. However, a direct merger into Acquirer would subject the assets of Acquirer to Target’s liabilities. The transaction could also require an Acquirer stockholder vote. The deal is revised so that Acquirer would form a single member LLC (SMLLC) into which Target would merge. SMLLC would be the survivor and Mary would still receive Acquirer’s stock. Because SMLLC is a disregarded entity, the parties have assumed that the revised deal would still qualify as a tax-free reorganization under section 368(a)(1)(A).

In proposed regulations issued in May of 2000, the government concluded that the above revised structure would not qualify for tax-free treatment under section 368(a)(1)(A). The transaction, to be tax-free, would have to satisfy the more rigid requirements of section 368(a)(1)(C). In November of 2001, the 2000 proposed regulations were withdrawn and new proposed regulations were issued. The 2001 proposed regulations provided that a merger of a target corporation into a disregarded entity will qualify for tax-free treatment under section 368(a)(1)(A) (assuming all requirements are satisfied). On January 24, 2003, Treasury issued temporary regulations under section 368 that generally follow the 2001 proposed regulations. Note that even prior to the issuance of the temporary regulations, the Service had issued favorable letter rulings on this issue.

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92 Sections 332 and 337. See Reg. §1.337(d)-6 and 1.337(d)-7, for application of section 1374 built in gain principles in this context.
93 See Temp. Reg. §1.368-2T.
94 See, e.g., Ltr. Rul. 200236005 (5-23-02).
B. Example 2.

Assume the same facts as in Example 1 except that Acquirer has a wholly-owned subsidiary corporation, Subcorp, that owns all of the interests of SMLLC. Target will merge into SMLLC and Mary will still receive Acquirer’s stock. If SMLLC is disregarded for federal income tax purposes, the deal will be viewed as if Target merged into Subcorp, a transaction that would qualify as a forward triangular reorganization under section 368(a)(2)(D). Does the merger of Target into SMLLC change this result? The temporary regulations bless this transaction as well.\textsuperscript{95}

C. Example 3.

Assume the same facts as in Example 1 except that Acquirer is a limited partnership and SMLLC is wholly-owned by the Acquirer limited partnership. The merger of Target into SMLLC would not qualify as a tax-free reorganization under section 368(a)(1)(A) unless Acquirer has elected to be taxed as a corporation.\textsuperscript{96}

D. Example 4.

Assume that Target has substantially all of its assets in a single member LLC subsidiary, Target LLC. Target LLC, a disregarded entity, will merge into Subcorp, an Acquirer subsidiary corporation. Target will receive Acquirer’s stock. A merger of a disregarded entity into a corporation will not qualify as a tax-free reorganization under section 368(a)(1)(A).\textsuperscript{97} This transaction could qualify for reorganization treatment under section 368(a)(1)(C) if all of the requirements are satisfied (including liquidation of Target and Target LLC assets must be “substantially all” of the assets of Target, etc.). The reorganization under section 368(a)(1)(A) offers maximum flexibility in terms of consideration, pre-merger asset dispositions, etc. A reorganization under section 368(a)(1)(C) is more difficult to achieve.

E. Example 5.

Assume that Acquirer is a publicly traded REIT. Target is an S corporation that is subject to the 10-year built-in gain rules of section 1374 because Target elected S status during the past 10 years. Acquirer owns 100% of the stock of QRS, a qualified REIT subsidiary that is disregarded for federal income tax purposes. Target merges into QRS with QRS surviving. The stockholders of Target receive stock in Acquirer. This transaction qualifies for tax-free treatment under section 368(a)(1)(A).\textsuperscript{98}

F. Example 6.

Assume that Spin Corp is an S corporation that has been engaged in the widget manufacturing business for the past 30 years. Spin Corp is concerned about product liability

\textsuperscript{95} Temp. Reg. §1.368-2T(b)(1)(iv), Ex. 4.
\textsuperscript{96} Temp. Reg. §1.368-2T(b)(1)(iv), Ex. 5.
\textsuperscript{97} Temp. Reg. §1.368-2T(b)(1)(iv), Ex. 6.
\textsuperscript{98} Ltr. Rul. 200250023 (9-4-02). Note that in this letter ruling, this result was not impacted by the fact that QRS immediately contributed the Target assets to an UPREIT partnership in which QRS was the general partner.
exposure. Spin Corp owns 100% of the stock of Controlled Corp, a company that has been engaged in the home building business for more than 5 years. Controlled Corp is a QSUB, a disregarded entity. Spin Corp would like to spin off the stock of Controlled Corp to the Spin Corp stockholders in order to protect Controlled Corp from the liabilities of Spin Corp. Can this be done without adverse tax consequences?

The Service issued a favorable ruling on these facts. Both Spin Corp and Controlled Corp have been engaged in the active conduct of a trade or business for more than five years and the spin-off achieves a valid corporate business purpose (i.e., risk reduction). The distribution of the Controlled Corp stock will terminate the QSUB election because Controlled Corp will cease to be wholly-owned by Spin Corp. As a result, Controlled Corp will be treated as a new corporation for federal income tax purposes, acquiring all of its assets and assuming all of its liabilities immediately prior to the spin-off. This fictional incorporation and distribution of Controlled Corp stock will qualify as a tax-free reorganization under section 368(a)(1)(D). Furthermore, Controlled Corp will be eligible to make an S election for its first taxable year beginning immediately after the spin-off.

IX. ACHIEVING FLEXIBILITY IN LIKE-KIND EXCHANGES THROUGH DISREGARDED ENTITIES

A. Example 7.

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

B. Example 8.

Assume the same facts as in Example 7, except that Swap LLC is owned by Tom, Dick and Harry. The moment before Davis 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. Has Davis complied with section 1031?

The transaction is treated as a sale of partnership interests by Tom, Dick and Harry, but it is treated as a purchase of assets by Davis. Consequently, the transaction is a good like-kind exchange for Davis. Of course, if Davis only acquired the interests owned by Tom and Dick, Davis would not have a good like-kind exchange because Swap LLC would not be a disregarded entity immediately after the purchase.

99 Ltr. Rul. 200306033 (11-5-02).
100 Section 1031(a)(2)(D).
C. Example 9.

Assume that Davis held his relinquished real estate in a single member LLC. Davis transferred all of the interests in LLC to Tom, Dick and Harry. Will Davis be permitted to treat his transfer of the LLC interests as a sale of the real estate owned by the LLC?

The transaction is treated as a transfer of assets by Davis to Tom, Dick and Harry. The transaction is treated as a transfer of assets by Davis to Tom, Dick and Harry. Tom, Dick and Harry are treated as contributing their fictional undivided interests in the assets to the LLC immediately thereafter. Thus, Davis will be entitled to structure a like-kind exchange. Note that if Tom, Dick and/or Harry were attempting to use the purchase as replacement property in their exchanges, they would have to contend with the "holding" requirement of section 1031.

D. Example 10.

Assume the same facts as in Example 9 except that Davis transferred only a portion of his interest in his single member LLC. Rev. Rul. 99-5 would still treat Davis as having transferred an undivided interest in the real estate owned by the single member LLC. Thus, Davis would still be entitled to 1031 treatment (assuming all requirements of section 1031 are otherwise satisfied) because he did not sell a partnership interest.

E. Example 11.

Suppose that Andy owns all of the stock of S Corp, an S corporation holding company. S Corp's only asset is 100% of the stock of QSUB, a qualified S subsidiary. QSUB owns investment real estate. Can S Corp structure a like-kind exchange of the real estate by disposing of the stock of QSUB? Stock is not good like-kind exchange property.

A 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. The purchaser is then deemed to have contributed the assets to QSUB in exchange for QSUB stock. Can S Corp 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? Based upon the regulations, it appears that the answer is "yes." However, a transfer of less than all of the stock would not "work" under current law.

F. Alternative Structure

For those taxpayers who wish to take another (perhaps safer) approach, the following alternative structure could be considered. S Corp forms 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

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103 See e.g., Magneson v. Commissioner, 81 T.C. 767 (1983), aff'd, 753 F.2d 1490 (9th Cir. 1985); Bolker v. Commissioner, 81 T.C. 782 (1983), aff'd, 760 F.2d 1039 (9th Cir. 1985).
104 1999-1 C.B. 434.
105 Section 1031(a)(2)(B).
106 Reg. §1.1361-5(b)(3), Ex. 9.
107 But see section 503 of the Subchapter S Modernization Act of 2003 (H.R. 2576 and S. 1201).
income tax purposes. S Corp can then sell the interests in Newco LLC and qualify for like-kind exchange treatment.108

G. Example 12.

Assume that Davis has transferred some investment real estate and wishes to do a like-kind exchange. Davis is a 10% member in Real Estate LLC and Edward is the unrelated 90% member. Real Estate LLC owns real estate that would qualify as good replacement property for Davis if Davis acquired the real estate from Real Estate LLC. What if Davis instead acquires Edward’s 90% membership interest? Does this work? Generally, an LLC membership interest is not good exchange property under section 1031. However, Rev. Rul. 99-6109 will give Davis the comfort that he needs. Here, Edward is treated as having sold an interest in an LLC. However, because Davis will own 100% of the membership interests in Real Estate LLC when the smoke clears, Rev. Rul. 99-6110 treats Davis as having acquired the underlying assets of the LLC.

H. Example 13.

Assume that each of Davis and Edward owns a 50% membership interest in LLCI. LLCI owns real property held for investment. Davis and Edward 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 1031.111 What if Davis and Edward 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. 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.112 Thus, LLCII is treated as “holding” the LLCI real property for investment to the same extent as LLCI, with no resulting threat to like-kind exchange treatment.113

X. LIABILITY SHARING WHERE DISREGARDED ENTITY IS GENERAL PARTNER

A. Example 14.

Suppose that Smith and Jones form a limited partnership, LP. Smith contributes $1 million to LP as a limited partner. Jones contributes $1 million to LP as a general partner. LP purchases Blackacre for $10 million using the $2 million of cash and $8 million of third party debt which is recourse to LP and therefore to Jones as the general partner. Jones bears the

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108 See Reg. §1.1361-5(b)(3), Ex. 2.
109 1999-1 C.B. 432.
110 Id.
111 See section 1031(a)(2)(D).
112 Reg. §1.708-1(c).
economic risk of loss with respect to the $8 million debt, so Jones has basis of $9 million. Smith has basis of $1 million.\textsuperscript{114}

The above analysis applies even if Jones only has $2 million of assets other than his interest in LP because the regulations provide a presumption of solvency for the taxpayer/partner.\textsuperscript{115} There is an anti-abuse rule where there is, based upon the facts and circumstances, a plan to circumvent or avoid the obligations to pay the recourse debt.\textsuperscript{116}

B. \textbf{Example 15.}

What happens if Jones forms Jones LLC (a single member LLC that is disregarded) and causes Jones LLC to own the general partner interest in LP. Assume that Jones LLC has no assets other than its interest in LP. In determining the extent to which a partner bears the economic risk of loss for a partnership obligation, obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity (assuming the owner of the disregarded entity has no personal liability with respect to the obligation of the disregarded entity).\textsuperscript{117} Thus, Jones LLC cannot be disregarded for this purpose. The LP debt is treated as nonrecourse debt because Jones LLC offers Jones protection from personal liability on the recourse debt. Jones and Smith each has $5 million in basis. Does it matter that Jones only has $2 million of assets other than his interest in Jones LLC? No. What if Jones has no other assets? It does not matter.

What if Jones has an obligation in the Jones LLC operating agreement (or otherwise) to fund the obligations of Jones LLC? The debt should then be viewed as recourse and this would be true under the presumption of solvency even if Jones has no other assets. In other words, the presumption of solvency applies only to the taxpayer/partner (or a "related person"). Jones LLC is not the taxpayer/partner (and it is not a related person). What if Jones LLC has $2 million of assets other than its interest in LP? In this case, the debt would be bifurcated into $2 million of recourse debt allocated to Jones and $6 million of nonrecourse debt allocated equally between Smith and Jones.

The proposed regulations provide that, once the net value of a disregarded entity is initially determined, net value is not redetermined unless the obligations of the disregarded entity change by more than a de minimis amount or there is more than a de minimis contribution to, or distribution from, the disregarded entity.\textsuperscript{118} How will the partnership know about the value of assets of a disregarded entity and changes in value? The burden is placed on the owner of a disregarded entity partner in this context to provide the partnership with the net value of the disregarded entity partner on a timely basis.\textsuperscript{119} There is an anti-abuse rule that provides that the net value of a disregarded entity is determined by taking into account a subsequent reduction in the net value of the disregarded entity if at the time of the determination of net value it is anticipated that the net value of the disregarded entity will subsequently be reduced and the

\textsuperscript{114} See Reg. §1.752-2(b)(1).
\textsuperscript{115} Reg. §1.752-2(b)(6).
\textsuperscript{116} Reg. §1.752-2(j).
\textsuperscript{117} Prop. Reg. §1.752-2(k)(1).
\textsuperscript{118} Prop. Reg. §1.752-2(k)(2).
\textsuperscript{119} Prop. Reg. §1.752-2(k)(5).
reduction is part of a plan that has as one of its principal purposes creating the appearance that a partner bears the economic risk of loss for a partnership liability.  

C. Example 16.

In 2005, Jones contributes $2 million to Jones LLC. Jones LLC purchases Whitacre for cash. On December 31, 2005 (when liability shares are determined), Whitacre has a value of $800,000. Because Jones' contribution of $2 million is more than de minimis, the net value of Jones LLC is redetermined as of December 31, 2005. The LP debt is bifurcated so that $800,000 is recourse and $7.2 million is nonrecourse.

D. Example 17.

What if, in 2006, Jones makes a gift of a 1% interest in Jones LLC to Mrs. Jones (in a non-community property state)? Jones LLC becomes a partnership for tax purposes. Jones LLC is allocated $8 million of basis because Jones LLC bears the entire economic risk of loss (under the presumption of solvency) unless the anti-abuse provisions of regulation §1.752-2(j) applies.

XI. DISREGARDED ENTITIES IN OTHER CONTEXTS

Proposed regulations were recently promulgated to address the liability of disregarded entities for federal taxes. Although a disregarded entity generally is not liable for federal tax liabilities of its owner with respect to taxable periods during which it is disregarded, the disregarded entity may be liable for federal taxes with respect to taxable periods during which it was not disregarded or because it is the successor or transferee of a taxable entity. These proposed regulations provide that, if a disregarded entity is liable for federal taxes, the disregarded entity will be treated as an entity separate from its owner for purposes of those liabilities. Thus, assessments may be made against the disregarded entity, the assets of the disregarded entity may be subject to lien and levy and the disregarded entity may consent to extend the period of limitations on assessment.

If a disregarded entity is entitled to a credit or refund of federal tax, the disregarded entity will be treated as an entity separate from its owner for this purpose. An owner of a disregarded entity has two choices for filing employment tax returns. One approach allows the owner to pay the employment taxes of the disregarded entity using the owner's name and EIN. The other approach is that the disregarded entity can pay employment taxes using its name and EIN. Regardless of the choice, the owner is the employer for purposes of employment tax liability.

In CCA2000338012, a disregarded entity LLC that filed Chapter 11 bankruptcy had paid payroll taxes in its name and using its EIN. The disregarded entity had a payroll tax balance due.

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120 Prop. Reg. §1.752-2(k)(3).
121 Prop. Reg. §1.752-2(k)(b), Ex. 2.
122 Reg. §1.752-2(c)(6).
123 Reg. §1.752-2(b)(1).
124 See Prop. Reg. §§1.856-9, 1.1361-4(a)(6) and 301.7701-2(c)(2)(iii).
125 Notice 99-6, 1999-1 C.B. 321.
126 CCA2000338012 (date note given).
The Chief Counsel’s Office concluded that this liability is a liability of the owner of the LLC. Note that the Service cannot reach the assets of the disregarded entity to satisfy a federal tax liability of the owner. The Service can collect withheld taxes from an “other person” but the Chief Counsel’s Office concluded that a disregarded entity is not an “other person.”

The Service recently concluded that a disregarded entity cannot be disregarded under section 6231. Section 6231 provides special audit procedures for partnerships (the “TEFRA audit rules”). Certain “small partnerships” are exempt from the TEFRA audit rules. A “small partnership” is defined as a partnership in which there are 10 or fewer partners, each of whom is an individual (other than a nonresident alien), an estate of a deceased partner or a C corporation. The regulations provide that the small partnership exemption does not apply if any partner during the taxable year is a “pass thru partner.” A “pass thru partner” is a partnership, estate, trust, S corporation, nominee or other similar person through whom other persons hold an interest in the partnership.

In Rev. Rul. 2004-88, LP, a limited partnership, has five partners, all of whom are United States resident individuals, except that the general partner owns his partnership interest through a single member LLC. The single member LLC is treated as the tax matter partner of LP because, under applicable state law, the single member LLC is the general partner of LP, and thus, the single member LLC is not disregarded for this purpose. The single member LLC is treated as a “pass thru partner” for purposes of the section 6231 small partnership exemption. Thus, the small partnership exemption is not available to LP. In other words, the single member LLC is not disregarded for this purpose. Note that if an election were made to treat the single member LLC as a C corporation, the small partnership exemption would be available.

Whether a disregarded entity will, in fact, be disregarded for federal tax purposes in any given situation remains to be seen. For example, under section 118 certain contributions to a “corporation” are not taxable. If a contribution is made to a disregarded single member LLC owned by a corporation, is section 118 available? The answer should be yes.

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127 But see In Re Albright, 291 BR 538 (Banker, D. Col. 2003).
128 Section 3505(a).
130 Section 6231(a)(1)(B).
131 Reg. §301.6231(a)(1)-1(a)(2).
132 Section 6231(a)(9).
133 2004 IRB 165.