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Choice of Entity - Flexibility, Exit Strategy

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I. Introduction.

In choosing an entity, a taxpayer should consider the flexibility of converting the selected entity into a different type of entity, the tax impact of a possible asset sale by such entity, a merger or consolidation with one or more other entities and the tax rules for distributions and equity interest transfers.

Proprietorships, partnerships and limited liability companies (taxed as partnerships) are more flexible than corporations. Generally, the flexible entities and S corporations are subject to less taxes upon an asset sale and distribution of net after tax proceeds than a C corporation. However, if an S corporation has assets which are not sold but distributed to its shareholders in liquidation, such shareholders often incur more taxes upon the completion of the asset sale and liquidation than the owners of the flexible entities.

Vertical and horizontal integration have increased throughout all industries, particularly in the service, finance, health care and manufacturing industries. This trend is resulting in a considerable increase in the number of affiliations, mergers, consolidations and asset and stock purchases and sales. Such affiliations can be through complete or partial integration of the business enterprises. In either case, the owners of the more flexible entities and S corporations generally achieve better tax results than owners of the C corporations.

II. Conversion of Existing Entity.

A. C Corporations.

1. C corporation to S corporation.

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a. **§ 1362(b) election.** Unanimous consent of all shareholders is required. Election effective as of the first day of taxable year if filed by 15th day of third month. If filed later, election is effective the first day of following tax year.

b. **Accumulated C Corporation Earnings & Profits.** If the C corporation had accumulated earnings and profits ("E&P") several problems could arise.

(1) No Ordinary Income Tax on Shareholder Distributions to Extent of AAA. If distributions to shareholders are equal to or less than the corporation’s accumulated adjustment account (AAA) the distribution will not be taxable as ordinary income to the shareholders. § 1368(c)(1). As to such shareholders the distributions are tax-free to the extent of their basis in their shares and then taxed as gain. § 1368(b).

(a) Distributions in excess of the corporations AAA are taxable as ordinary income to the extent of E&P § 1368(e)(2).

(b) §1368(e)(3) allows corporation to not apply the corporation’s AAA against a year’s distributions so that they will come first from C corporation E&P. This is all or nothing election. See PLR 895013 where IRS disallowed attempt to treat only a portion of year’s distribution from C corporation earnings.

(2) Tax on "passive" investment income. If the S corporation has C corporation E&P and passive investment income which exceeds 25% of gross receipts, then a tax equal to the highest C corporation tax rate is imposed on the corporation’s excess net passive income § 1375(a).

(3) Possible termination of S corporation status. If the S corporation has C corporation E&P and gross receipts more than 25% of which are passive income for three consecutive years the S corporation status is terminated. § 1363(d)(3). Exception: (PLR 9349017) S corporation had excess passive investment income for three years but termination was avoided provided corporation distributed C corporation E&P and paid a "toll charge" (ordinary income tax rates on distribution of C corporation E&P).
c. § 1374. The built-in gain tax is the biggest deterrent to making a C to S conversion. The tax potentially applies if at the time of conversion the C corporation had assets with a fair market value that exceeded the adjusted bases of those assets on the first day of the first S corporation tax year. The proposed regulations do not require that each individual asset be valued to determine the Net Built-In Gain (NUBIG). Prop. Regs. § 1.1374-3(a)(1)-(5). The tax is triggered on the sale or exchange of those assets. The tax will not be imposed if the S corporation can show that a built-in gain did not exist at the time of the conversion.

(1) NUBIG calculation.

(a) Amount Realized by the C corporation (including assumption of corporate liabilities) in a hypothetical sale of all corporate assets on the first day of the recognition period to an unrelated party reduced by

(b) Liabilities that are deductible when paid (e.g. accounts payable) reduced by

(c) The aggregate adjusted basis in all corporate assets increased or decreased by

(d) Corporate § 481 (accounting method changes) adjustments on the first day of the recognition period and recognized built-in losses allowed under §§ 382, 383, and 384. Treas. Regs. § 1.1374-3(a)(1)-(5).

(2) Rev. Rul. 86-141. 1986-2 CB 151. If corporation made S election after 1986 and before 1989, it was not subject to § 1374 for long term capital gain property if the corporation was less than ten million dollars in value and held by 10 or fewer shareholders.

(3) Maximum Corporate Rate. The tax rate applied to the built-in gain is the highest C corporation rate at the time the built-in gain is recognized by the corporation as a result of a sale, exchange or distribution § 1374(b)(1).

(4) 10 year recognition period. The built-in gain taint lasts for ten years. After that time, a sale or taxable exchange will
not result in the imposition of the maximum corporation rate.

(5) Loss Offset. Recognized built-in gains can be offset by any built-in loss or deduction recognized in the same taxable year.

(6) PLRs 9106009 and 9117055. A suspense account created for a § 481 adjustment relating to change from cash to accrual method of accounting should not be accelerated as a result of an S election but would be subject to built-in gains tax to the extent of any reduction or recapture. Presumably the same rules apply for a suspense account set up under § 447(i).

(7) Receivables. Built-in gain will be triggered by S corporation's collection of receivables earned by corporation prior to effective date of S corporation election if corporation was on the cash method of accounting before and after its S corporation election. To avoid this result, the corporation's board of directors should accrue built-in deductions attributable to the generation of receivables. In a professional corporation this is usually accomplished by accrual of bonuses to shareholder-professionals. Otherwise, the S corporation's income attributable to receivables will be subject to built-in gain tax. 731 T.M. Portfolio at A-20; See, Leou v. Commissioner, T.C. Memo 1994-393. A cash-method medical services business that held accounts receivable on its last day as a C corporation was required to treat amounts collected on those accounts during the next year, for which it had elected S status, as net recognized built-in gain.

d. **Tax Year under § 1378.** An S corporation must adopt the calendar year or a "permitted year". The rule under prior law that allowed a taxable year that deferred income for three months or less is gone. Temp. Reg. § 1.442-2T(b). Therefore an S corporation may lose its fiscal tax year unless it has a satisfactory business purpose for choosing a non-calendar year.

(1) The major exception is where desired year end is the same year end as the majority in interest of S corporation owners. Rev. Proc. 87-32, § 4.01(2), 1987-2 CB 396.
(2) The satisfactory business purpose requirement is rarely met. Rev. Rul. 87-57, 1987-2 CB 117. Exception applies if the corporation received 25% or more of annual gross receipts during the last two calendar months of its desired year for three consecutive years. Rev. Proc. 87-32, § 4.01(1), 1987-2 CB 396.

(3) Under § 444 which in effect overrides § 1378, an S corporation may elect to use a fiscal year provided generally that it does not defer income for the shareholders for more than three months. §7519 requires corporation to make interest free deposit with the IRS in instances of deferral under § 444.

e. **Accounting Method.** Rev. Proc. 84-74, 1984-2 CB 736. If corporation changes accounting method, §481 adjustment may take place over several years.

f. **§ 1363(d).** LIFO recapture for C corporation using LIFO method of inventory valuation. If the value of the inventory as determined using FIFO exceeds the value using the LIFO method, the excess is added to the taxable income for the last C corporation year. Payment of these incremental taxes can be made in four equal annual installments.

g. **§ 1371(b).** Loss of Carryforwards and Inability to Carryback. Carryforwards can not be used during any year in which the corporation is an electing S corporation, but S corporation years are counted in determining the expiration of the carryforward period. Therefore, a C corporation with net operating loss carryforwards may lose the benefit of the carryforwards forever.

h. **§ 1371(a)(2).** An S corporation owning shares in another corporation will be treated as an individual for purposes of Subchapter C. This results in a loss of the § 243 dividend received deduction.

i. **§ 613A(c)(13)(C)(ii).** A deemed transfer of all C corporation properties is considered to take place on the effective date of the election. Transfers of oil and gas properties with proven reserves may inhibit the use of percentage depletion under §613A(c)(9). However, see PLR 8510054 (12/11/84) where such a transfer did not require termination of the depletion method.
j. § 1373(b). Making the election is treated as the disposition of the business for §904(f). Therefore, the election may trigger the recapture of overall foreign losses previously taken into account by the electing corporation.

k. § 1372(a). An S corporation is treated as a partnership for purposes of employee fringe benefits. Any individual who owns, directly or indirectly, more than two percent of the outstanding stock or combined voting power of the corporation will be treated as a partner for these purposes. This prevents shareholders of the S from excluding income fringe benefits such as accident and health plan payments, group term life insurance, and employer-provided meals and lodging. These items are only excludible by an "employee".

l. § 4975(d)(1). The exemption of loans made on a nondiscriminatory basis and on commercially reasonable terms, made by a qualified plan to a plan participant, does not apply to loans made to an "owner-employee". An officer or director who owns more than five percent of an S corporation, either directly or indirectly, on any day of the tax year is considered an "owner-employee".

m. Passive Loss Rules. In the S corporation the activities of the corporation will be considered passive activities for any shareholder who does not materially participate. The effect of § 469 is to restrict the income deduction of "passive" losses except to the extent the taxpayer has passive income. The passive income can be from the same or a different activity. The passive losses that can not be utilized in any given year are suspended until they can be used to offset passive income or until the taxpayer disposes of his entire interest in the corporation. Although § 469 applies to closely held C corporations, the provisions regarding the deductibility of passive activity losses are less stringent than those applicable to individuals. For instance, the passive activity losses of a closely held C corporation may be used to offset nonpassive income other than portfolio income. § 469 (e)(2).

n. Recovery of Interest Expense Deductions. S shareholders must include in income recovery of interest expense previously deducted by C corporation. See e.g., PLR 9202002 where IRS applied inclusionary aspect of Tax Benefit Rule.
2. C corporation to LLC or Partnership.

a. Liquidation of Corporation.

(1) C corporation shareholders, and the holders of S corporation stock, if such corporation is subject to the built-in gains tax, are subject to double tax on distribution of appreciated property.

(2) Distributions may be tax-free at the corporate level if property has depreciated or the corporation has significant tax losses. Taxability to the shareholder will be dependent on the amount of liquidating distribution received in relation to the shareholder’s basis in his or her stock (Caveat, collapsible corporations § 341).

(3) Three Methods of Liquidation (See Section III, infra for tax effect of Three Options) -

(a) Liquidation of corporation into LLC formed by corporation’s shareholders who transfer stock to LLC immediately before liquidation.

(b) Formation of LLC by a corporation and its shareholders followed by a corporate liquidation to a LLC.

(c) Liquidation of a corporation followed by formation of a LLC by corporation’s shareholders and transfer of assets and liabilities received by shareholders to LLC.

b. Alternatives to Immediate Double Taxation.

(1) Parallel operations started up by a LLC, or another entity, in connection with abandonment of the corporation. This transaction had potentially disastrous tax consequences.

(a) Compensation payments made to shareholder employees may be recharacterized as dividends.

(b) Corporation may be deemed to have transferred its goodwill and other intangibles to the LLC in a...
taxable distribution to its shareholders followed by a § 721 contribution to the LLC.

(c) IRS may allege that corporation has constructively liquidated, subjecting shareholders to double level of taxation.

(2) Installment Sale followed by Liquidation. Shareholders form LLC with new capital and the LLC purchases the assets of the corporation in installment sale. Corporation is subsequently liquidated. Gain on installment note will be recognized by corporation when it is distributed to shareholders except for liquidation of subsidiaries under § 337(a) and qualifying liquidations of S corporations. See § 453B(h). Shareholder’s gain is generally deferred until payments on the installment obligation are received if the liquidation qualifies under § 453(h). However, this rule does not apply if the maker and the corporation are related taxpayers under § 1239(b) and to the extent the note is attributable to depreciable assets and intangibles amortizable under § 197. See § 197(f)(7). Recapture income is taxable to the corporation upon disposition at the time it is distributed by the corporation regardless of corporation’s relationship to the maker. § 453(i).

(3) Parallel Operations.

(a) Combined with sale of assets.

(b) Combined with leasing or licensing of assets.

   i) Not a good approach if assets within corporation are appreciating in value.

   ii) Value of leasing the intangibles subject to IRS attack.

(4) Joint Venture. Corporation becomes member of existing LLC formed by corporate shareholders. Corporation contributes the business and the shareholders contribute new equity.

   (a) Value of business subject to IRS scrutiny.

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(b) Joint Venture with a freeze of corporation's interest in LLC can reduce problems with future appreciation. Corporation gets preferred return but can not participate in future appreciation of business.

B. S Corporations.

1. S corporation to C corporation.

   a. No direct tax consequences.

   b. Close of tax year. § 1362(e). Results in short S and short C tax years. Tax for short C year determined on annualized basis.

   c. § 1366(d)(3). If a loss or deduction was disallowed in the last S year due to lack of shareholder basis, then such loss is treated as having been incurred by the shareholder on the last day of the "post-termination transition period". The post termination transition period is defined in § 1377(b)(1) as the period (i) beginning on the day after the corporation's "last day" as an S corporation and ending on the later of one year from the last day or the due date for filing the last S tax return (including extensions) for the last year as an S corporation or (ii) the 120 day period beginning on the date of a determination that the corporation's S election terminated for a prior year. Note, however, that this loss can not exceed the shareholder's basis as determined on the last day of the post-termination period. Therefore, the shareholder can use the suspended loss if he increases his basis during the post-termination period.

   d. § 1371(e). Cash distributions made from the C corporation during the post termination transition period are treated as nontaxable return of basis, rather than taxable dividends, to the extent the distributions do not exceed the AAA of the former S.

2. S Corporation to LLC or Partnership. The liquidation of a S corporation is a taxable event. The difference between a S corporation liquidation and that of a C corporation is that the S corporation liquidation does not result in double taxation (unless the S corporation is subject to the built-in gains tax). Gain is recognized by the S corporation in the liquidation, but the S shareholders receive an increase in their basis to reflect the gain on the difference between the fair market value and the basis of the assets distributed. Therefore, the S corporation's gain reduces
the gain otherwise recognizable by the shareholders upon receipt of the liquidating distribution.

a. **S Election Termination.** Transfer of the stock to the LLC or Partnership terminates the S corporation election. Unless the liquidation occurs on the same day as the transfer, the corporation has a short S year and a short C year in the final year of its existence.

b. **Termination Avoidance.** Liquidation into the shareholder's hands avoids the termination of the election and short S and C years.

C. **Partnerships and LLCs.**

1. **Partnerships and LLCs to C or S corporations.** The form of the incorporation is respected. Rev. Rul. 84-111, 1984-2 CB 88.

a. **Contribution of Partnership or LLC Assets in Return for Stock.**

(1) § 351. Tax free to Shareholder provided the requirements of § 351 are met and liabilities of transferor (i) are not assumed by corporation pursuant to a plan the principal purpose of which is avoidance of Federal income tax or is not a bona fide business purpose or (ii) do not exceed the basis of assets transferred to the corporation by the transferor. § 357(b) and (c). Liabilities, the payment of which either give rise to a deduction or are described in § 736(a) are not included in the computation of liabilities for such purpose. § 357(c)(3).

(a) Transferors of property must be in control (at least 80% of combined voting power of all classes of stock entitled to vote and at least 80% of total number of shares of all other classes of stock, including at least 80% of each class of nonvoting stock. Rev. Rul. 59-259, 1959 CB 115) immediately after the exchange.

(b) Property includes all assets except services, debt of the transferee corporation not evidenced by a security and interest that has accrued on an obligation of the transferee corporation during the shareholder's holding period.

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i) Certain assets created by the performance of services (e.g. goodwill, patents) can be property provided in the case of patents, for example, all substantial rights in the patent are transferred and the transaction does not constitute a license. Rev. Rul. 69-156, 1969-1 CB 101 and Rev. Rul. 64-56, 1964-1 CB 133.

ii) Stock received for performance of future services subject to "substantial risk of forfeiture" is a problem area.

(2) § 1032. Corporation recognizes neither gain nor loss on issuance of its own stock.

(3) § 731. Distribution of the stock to the former partners is nontaxable.

(4) § 358(a). Corporation has a carryover basis in the assets of the partnership.

(5) § 732(b). Shareholder’s stock basis equals their partnership interest basis as determined immediately before the transaction.

b. Transfer of Partnership Interests to Controlled Corporation in Exchange for Stock. The corporation’s acquisition of all the partnership interests would cause the partnership to automatically terminate under local law.

(1) Corporation’s basis in the assets equals the basis of the former partners in their partnership interests.

(2) Shareholder’s stock basis equals basis in their partnership interest immediately before the contribution.

c. Liquidation of Partnership followed by Transfer of Assets to a Controlled Corporation.

(1) Gain recognition to partner if the money received, including any decrease in the partner’s individual liabilities, or share of partnership liabilities, is greater than the basis in his partnership interest. In general, a partner’s share of recourse liabilities equals the portion of that liability for
which that partner or related person bears an economic risk of loss. Reg. § 1.752-2(a). A partner’s share of nonrecourse debt equals the sum of (a) § 704(b) minimum gain (b) § 704(c) gain and (c) the partner’s share of excess nonrecourse liabilities allocated on the basis of the partner’s share of partnership profits. § 1.752-3(a). An economic risk of loss is an obligation to make payment on a liability which does not give the payor the right to reimbursement from another person. Reg. § 1.752-2(b). A partnership liability is a "recourse liability" to the extent that any partner or related person bears the "economic risk of loss." Reg. § 1.752-1(a)(1). A partnership liability is a "nonrecourse liability" to the extent that no partner or related person bears the "economic risk of loss." Reg. § 1.752-1(a)(2).

(2) § 732(b). Corporation’s basis in the assets would equal the basis partners had in their partnership interests less money they received in the liquidation.

(3) Shareholder’s stock basis would equal the basis the partners had in their partnership interests less money they received in the liquidation.

d. Eligible Shareholder Requirements of a S corporation.

(1) TAM 9001042. Momentary ownership of S corporation stock by partnership did not terminate S election of inactive corporation.

(2) PLR 8934020. General Partnership converted to S corporation by transferring assets and liabilities to S corporation in exchange for stock and partnership distributed stock to its partners within 30 days of asset transfer. Momentary ineligibility disregarded because part of a plan to incorporation.

2. Partnerships to LLCs.

a. Nonrecognition of Gain or Loss on Contribution. The contribution of a partnership interest to the partnership is not considered a sale or exchange. § 721
b. **Partnership to LLC conversion is nontaxable.** See, Rev. Rul. 95-37, 1995-17 IRB 10, PLRs 9350013, 9226035 and 9029019 (GP to LLC), and PLRs 9010027 and 9119029 (LP to LLC).

(1) No § 708 termination because the formation of the LLC is a deemed § 721 transaction.

(2) Tax year does not close and tax year does not change unless permission to change is obtained from the IRS. Reg. § 1.441-1T(b)(4).

(3) Conversion does not constitute a sale, exchange or liquidation of the partner's entire interest under § 706(c)(2)(A).

(4) Absent a termination, a new EIN is not required.

   (a) Rev. Rul. 63-257, 1963-2 CB 614. Sole proprietorship which incorporates is required to obtain a new EIN because the corporation is a separate legal person.

   (b) Rev. Rul. 73-256, 1973-2 CB 404. In statutory merger followed by reincorporation, new EIN not required because the two corporations are same corporation for federal income tax purposes although separate legal entities under state law.

(5) Beware of changes in debt from recourse to nonrecourse. If partnership debts are reallocated because of the conversion, § 752 and § 731 may require the partners to recognize gain.

c. **Cash Method of Accounting.** Partnerships are permitted to use the cash method of accounting if the partnership is not determined to be a tax shelter and has no corporate partners (see IV C2, infra). In practice, many professional service partnerships use the cash method to avoid early recognition of income on receivables. In this instance, complications arise if a conversion requires a change to the accrual method and the imposition of a § 481 adjustment.

   (1) As a general partnership, a professional services firm is not regarded as a "tax shelter" for purposes of § 448(a)(3).
However, once converted to an LLC, the limited liability protection may result in classifying the professional service firm as a "syndicate" with limited entrepreneurs. This would have the effect of forcing the accrual method of accounting and accelerating income recognition in the year of conversion.

(2) PLR 9321047. Determined that the cash method of accounting could be retained by a law firm operating as a partnership which proposed converting to a LLC. The ruling is narrow in its applicability in that the IRS determined that the members of the LLC would not be limited entrepreneurs because the members would actively practice law and participate in management.

(3) PLR 9525065. Determined that cash method of accounting could be retained by accounting firm. Again IRS noted that members will continue to engage in activities of the firm and participate in management. Taxable year and EIN not altered.

d. **Employment Tax Concerns.** A general partner's distributive share of partnership income is self-employment income, while a limited partner's share is not. It is unclear how the member of an LLC will be treated. Most likely, members who participate in management will be treated like general partners.

e. **Tax Matters Partner.** § 6231(a)(7) provides that a TMP is the general partner designated as such, or the general partner with the largest profits interest. Since LLCs don't have general partners it is unclear that simply designating a member as TMP will be sufficient.

### III. Liquidations and Terminations.

A. **Liquidation of C and S corporations.**

1. **General Utilities Doctrine:** Based on the decision in General Utilities and Operating Co. v. Helvering, 296 US 200 (1935), under prior law a corporation did not recognize gain or loss on the distribution of assets in a complete liquidation.

a. **Old § 337.** Revoked as part of TRA of 1986, former § 337 ordinarily eliminated a tax at the corporate level on liquidation sale
transactions whether made directly by the corporation or imputed to it.

b. § 336 was amended in 1986 to require full recognition of gain or loss at the corporate level on the distribution of corporate assets in liquidation of the corporation. This provision effectively repealed the *General Utilities* doctrine.

2. **Shareholder Tax Effects.**

a. **Stock Sale.** Generally, the sale of stock to a third party produces capital gain or loss (Caveat, collapsible corporations, §341 and sale of stock to commonly controlled corporation § 304). Likewise, the receipt of a portion of a corporation's assets in liquidation of the corporation results in the recognition of capital gain or loss by a shareholder. § 1001. If the entity is an S corporation the tax basis of the shares are determined in accordance with § 1367.

b. **Cash or Property Distributions.** Under § 331(a) a taxpayer is treated as having exchanged his stock for the amount of consideration received in liquidation of the corporation. If the consideration is property, the amount realized will equal the net fair market value of the property.

c. **Basis in Property Received.** The basis in the hands of the taxpayer for any property received is the fair market value of the property at the time of distribution (§ 334(a)).

d. **Redemptions.** Note difference from treatment for some redemptions. If an S corporation shareholder receives proceeds in a redemption that is characterized as a distribution under § 301, the entire redemption is treated as a distribution for purposes of § 1368 that reduces the corporation's AAA. Rev. Rul. 95-14, 1995-6, 29.

3. **Corporate Level Tax Effects.**

a. **Stock Purchase.** The sale of a corporation's stock to a third party has no tax effect on the corporation unless the purchaser and corporation are members of the same affiliated group. In that instance, § 304(b)(4) requires adjustments to the adjusted basis of intragroup stock and the earnings and profits of any member of such group.
b. **Cash or Property Distributions.** The distribution of cash has no effect on the corporation other than to reduce its AAA on E&P accounts. However, under § 336(a) the corporation will recognize gain or loss on the distribution of property.

(1) § 336(b). If the distributed property is subject to a liability the fair market value of the property is deemed not to be less than the amount of the liability.

(2) § 336(d)(1). Corporate loss recognition may be denied on distributions to "related persons" as defined in § 267. The loss is denied if (a) the asset distributed to the related person varies in relation to his pro rata share based on his stock ownership or (b) the distribution was pro rata but the corporation acquired the distributed property within five years of the distribution in a § 351 transaction or as a contribution to capital.

(3) § 336(d)(2). For built-in loss property obtained in a § 351 transaction, as a contribution to capital, or as part of a plan, a principal purpose of which is to enable the corporation to claim a loss, losses realized on the distribution of that property are disallowed up to the amount of the built-in loss.

(4) § 1239. If Distributee owns more than 50% of corporation's stock then all of the corporate gain on the distribution of property subject to the allowance for depreciation under § 167 (or that would be subject to such an allowance but for an election by the corporation of a different deduction such as those allowed under §§ 169, 188 and 191) shall be treated as ordinary income. Reg. § 1.1239-1(a). Property, although not defined, should include tangible and intangible property provided it would be subject to an allowance for depreciation under § 167 and presumably § 197 in the hands of the distributee.

c. **Income Tax Liability.** Recognized gain creates an income tax liability at the corporate level for all C corporations and those S corporations with § 1374 built-in gain. The gain also passes-through to the shareholders of the S corporation resulting in double taxation to S corporations subject to the built-in gains tax and their shareholders.
4. **Liquidation/Reincorporation Dangers.** Often times shareholders will liquidate a corporation to avoid dividend treatment that would otherwise result on account of a distribution and then reincorporate an operating portion of the company. The IRS often uses the "Step Transaction Doctrine" to combine the two transactions. *See generally, Minnesota Tea Co. v. Helvering*, 302 US 609 (1938) at 613 and *Walter S Heller*, 2 TC 371 (1943) at 383, for a discussion of this judicial doctrine. After combining the transactions, the IRS will recharacterize the transaction as a tax-free reorganization under § 368 and a taxable distribution of earnings and profits. For the successful application of this approach by the IRS see generally, *Davant v. Comm*, 366 F2d 874 (5th Cir. 1966), *cert denied*, 386 US 1022 (1967) and *Reef Corp v. Comm.*, 368 F2d 125 (5th Cir. 1966).

**B. Terminations and Liquidations of Partnerships and LLCs.**

1. **Partnership Termination for Tax Purposes.** The termination of a partnership for federal income tax purposes is not dependent on local partnership law.

2. **Partner Tax Effects.**
   
a. **No gain.** Under § 731(a)(1), gain is generally not recognized by the partners or members except to the extent any money received, including relief of indebtedness, exceeds their basis in their partnership interest as computed immediately before the distribution. Note, ordinary income or loss is recognized upon the distribution and subsequent sale of "hot assets" (unrealized receivables and inventory) by a partner. The ordinary income taint is indefinite for unrealized receivables, whereas the taint only lasts five years for the inventory if the partner has converted it into a capital asset. § 735(a). In determining the partner's holding period for inventory, the holding period of the partnership does not tack. § 735(b).

b. **No loss.** Under § 731(a)(2), loss is not recognized except when only money, unrealized receivables and inventory, are distributed. In that instance, loss is recognized to the extent that the partner's basis in his partnership interest exceeds the money distributed plus the distributee partner's basis in the unrealized receivables and inventory received.

c. **Basis of Property Received.** Under § 732(b), the partner will take a basis in the distributed property (other than money) equal to
the adjusted basis of the partner's interest in the partnership reduced by the amount of any money received. The basis of the property is allocated as follows:

(1) unrealized receivables and inventory items in an amount equal to the adjusted basis of each property to the partnership; and

(2) other property in proportion to their adjusted bases to the partnership. §732(c).

3. Tax Effects to Partnership. Under § 731(b) distribution of property in liquidation of a partnership results in no gain or loss to the partnership.
   a. No depreciation recapture. § 1250(d)(3).
   b. No recapture of investment tax credit. Reg. § 1.47-3(f)(1).

IV. Mergers.
   A. Mergers using S corporations.
      1. Termination of S corporation election.
         a. TAM 9245004. If S corporation acquires Target stock and immediately (within 30 days) liquidates Target into itself, S corporation election preserved.
         b. PLR 9152019. Termination avoided despite failure to liquidate Target within 30 days. S corporation acquired all the stock of Target, intending to liquidate within 30 days, but attorney failed to file the documents on time.
         c. Rev. Rul. 70-232 1970-1, CB 178. Where two S corporations consolidated in "A" reorganization, there was no termination of the S election. § 1362(d) not applicable.
2. **Re-election of S corporation Status.** Under § 1362(g) if corporation has made an election and S status is subsequently terminated, that corporation or its successor can not make another S election for five years without consent of IRS.

   a. **PLR 9323032.** C corporation bought all the stock of S corporation ending its S status. Four months later C corporation merged into former S corporation and filed a new S election. IRS later discovered the problem but allowed the election to stand because the termination was not reasonably within control of the acquiring corporation, or shareholders having a substantial interest in the acquiring corporation, and terminating the election was not part of the acquisition plan.

   b. **PLR 9419010.** S re-election allowed where corporation revoked S election and new shareholders later acquired all the stock. The fact that more than 50% of the stock in a corporation is owned by persons who did not own stock at the time of the termination tends to establish a reason for IRS consent. § 1.1362-5(a).

   c. **PLR 8648037.** S corporation purchased 100% of Target stock. Target was not eligible to elect S because it had subsidiaries, so S corporation merged downstream into Target. Three years later, after liquidating its subsidiaries, Target made an S election. IRS ruled that election was valid, permitting the corporation to forgo the usual five year waiting period. IRS reasoned that the subsequent S election was not prohibited because the acquiring S corporation’s S status had not terminated during its last taxable year.

3. **Carryover of Tax Attributes.**

   a. **Accumulated Adjustment Account.** If Target and Acquiror are S corporations, Acquiror succeeds to Target’s AAA. PLRs 9002051 and 9309033.

   b. **Earnings and Profits.** Acquiror generally succeeds to Target’s E&P under § 381(c)(2).

B. **Mergers of Partnerships.**

1. **Resultant Partnership deemed Continuation of Former Partnership.** The partnership resulting from a merger or consolidation of partnerships is considered the continuation of such partnership whose members own a 50 percent or more capital or profits interest in the resulting partnership.
§ 708(c)(2)(A). If partnership can be considered the continuation of more than one partnership, it shall be treated as the continuation of the partnership that contributes the greatest dollar value of assets to the merger or consolidation. The other partnerships which are parties to the transaction will be deemed to have terminated. If none of the merging partnerships receive more than a 50% interest in the capital and profits of the resulting partnership, all the partnerships are deemed to have terminated. Reg. § 1.708-1(b)(2)(i).

2. Continuity analysis under §§ 721 and 731.

a. Rev. Rul. 90-17, 1990-1 CB 119. In a merger of three partnerships, if the resulting partnership is determined to be a continuation of any one of the merging partnerships under § 708(b)(2), then a § 731 distribution by the other partnerships of capital and profit interests of 50% or more in the resultant partnership will not cause a § 708(b)(1)(B) termination.

b. Rev Rul. 68-289, 1968-1 CB 314. In a merger the noncontinuing partnership was deemed to have contributed its assets to the surviving partnership under §721 followed by a distribution of the partnership interests to its partners in a §731 liquidating distribution.

c. Deemed recognition of gain for partners of terminating partnership.

(1) Reduction in liabilities of terminating partnership may result in §752(b) distribution because terminating partnership and not the partners contribute the assets and liabilities to the surviving partnership.

(2) Merger of commonly owned partnerships. If terminating partnership has disproportionate liabilities, its partners may recognize gain from § 752(b) distribution even in the absence of any change in percentage interests, because they can not use their basis in the continuing partnership to reduce §752(b) distribution from terminating partnership. PLR 7805028.

3. General Partnership and Limited Partnership. Use of merger to convert GP into LP is most likely to be scrutinized by IRS under conversion rules. Therefore, the transaction will generally not be taxable under § 721. Rev. Rul. 84-52, 1984-1 CB 157.
4. **General Partnership into Limited Liability Partnership.** Transaction will not result in §708 termination when partner's interests in capital, profits and losses remain the same. PLR 9426037.

C. "Partial Integration" the Use of Partnerships of Corporations.

1. **Partnerships of S corporations.** S corporations may invest in partnerships. The limitations on these types of arrangements is uncertain given the current status of relevant authority.

   a. **Rev. Rul. 94-43, 1994-2 CB 198 revoking Rev. Rul. 77-220.** S corporation will not lose its S status by becoming a partner in a partnership when the purpose of the transaction was to avoid the 35 shareholder limitation. Ruling states that the purpose of the shareholder limitation was to maintain simplicity in administering corporate tax reporting. Concluding that the purpose was not circumvented by the utilization of the S corporations as partners the IRS ruled that such an arrangement "does not increase the administrative complexity at the S corporation level." At least one commentator has opined that this approach implies that a partnership of S corporations does not call into question any of the three major Subchapter S limitations (number of shareholders, single class of stock and shareholder eligibility). R. Blau, B. Lemons, and T. Rohman, "S corporations: Federal Taxation" §20:41 page 22.

   (1) **GCM 36966.** Characterized the transaction entered into in Rev. Rul. 77-220 as one entered to merely avoid the shareholder limitation. GCM 36966 was revoked by GCM 39886 following the issuance of Rev. Rul. 94-43.

   (2) **Contrast, Rev. Rul. 77-220, 1977-1 CB 263.** IRS ruled that a partnership of S corporations formed for the principal purpose of avoiding the shareholder limitation of subchapter S was a sham. All three corporations were treated as a single corporation and each corporation lost its S status. The "principal purpose" reasoning was seemingly at odds with the language of GCM 36966 and lead to later confusion in the issuance of several PLRS.

   (a) **PLRs 9050021, 9026044, and 8950066.** Allowed the use of S corporations as partners in partnerships where the principal purpose of the arrangement was not to avoid a limitation of Subchapter S.
(b) PLRs 9026025, 9025022, and 9025036. Describing Rev. Rul. 77-220 as a "principal purpose" ruling. However, these letter rulings noted that the partnership of S corporations will not be deemed a sham if it had economic substance and did not have as its principal purpose the avoidance of Subchapter S limitations.

b. **Taxable Year.** The selection of a taxable year by an S corporation may be restricted due to its ownership of a partnership interest.

(1) Although Rev. Proc. 87-32 allows an S corporation to select a taxable year corresponding to a period ending with any two months where 25% of the annual gross receipts of the business are realized, it does not allow this treatment for S corporations owning partnership interests. Rev. Proc. 87-32, 1987-2 CB 396, Sec. 3.01(2)(c).

(2) S corporations may also normally select a taxable year end which is the same as the fiscal year of shareholders owning a majority of interest in the corporation. Rev. Proc. 87-32, Sec. 4.01(2). However, S corporations owning interests in a partnership are prohibited from using the "ownership" test to establish a business purpose. Rev. Proc. 87-32, Sec. 3.01(2)(c).

2. **Cash Method of Accounting.** Generally, under § 448 a C corporation or a partnership which has a C corporation as a partner can not use the cash method of accounting.

   a. **C corporations which are qualified personal service corporations can use the cash method if the other § 448 requirements are met.**

   (1) Function Test. If "substantially all" of the corporation’s activities for the taxable year involve services in designated fields (e.g. health, law and accounting) then the corporation meets the function test. Substantially all requires the 95% of all time spent by employees is devoted to performing services in the qualifying field. Reg. § 1.1448-1T(e)(4)(i).
(2) **Ownership Test.** If "substantially all" of the corporation's stock is held directly or indirectly by employees, retired employees, the estate of an employee or any other person who acquired the stock by reason of an employee's death, for all of the taxable year, then the corporation meets the ownership test. Substantially all means greater than or equal to 95% of the value of all existing stock. Reg. § 1.448-1T(e)(5)(i).

b. **Exception for Entities with Gross Receipts less than $5,000,000.** A prohibited entity (i.e., C corporation or partnership with a C corporation partner) may use the cash method if the average annual gross receipts of the entity for the taxable year, and all prior taxable years beginning after 1985, were $5,000,000 or less for the past three years (including the current year).

c. **Application of Tax Shelter Prohibition.** The cash method of accounting is not available to a partnership of corporations if it is determined to be a "tax shelter".

(1) Any enterprise (other than a C corporation) offered for sale which is required to be registered by any federal or state agency with the authority to regulate the sale of securities shall be considered a tax shelter. Reg. § 1.448-1T(b)(1)(i).

(2) Any syndicate. A syndicate is any entity (other than a C corporation) which allocates for less than 35% of its losses to limited partners or limited entrepreneurs. Reg. § 1.448-1T(b)(3).

(3) Any tax shelter as defined by § 6661(b)(2)(C)(ii).