Changing Places: Tax Treatment of Changes in Choice of Entity

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INTRODUCTION

Many changes can occur in the life cycle of a business. In a number of instances, a taxpayer may want to change the form or type of entity through which a business is operated. This desire to change the type of business entity could arise from changes in the underlying business or as a result of changes in the tax law (such as the enactment of the Revenue Reconciliation Act of 1993). In such situations, the taxpayer needs to know the tax consequences of making the planned change. In addition, in some situations a well-advised taxpayer can avoid or defer adverse tax consequences while taking steps which have the same net economic effect as a change in the business entity.

I. GETTING STARTED. The first question which must be answered for a taxpayer is whether there are any tax consequences to the formation of a business.

A. Becoming a Sole Proprietor. There are no tax consequences when a taxpayer begins a business as a sole proprietor. The gain or loss from the business will be reported by the taxpayer on Schedule C to his or her return.

B. Incorporating a C Corporation. In general, the incorporation of a business is not a taxable transaction under Section 351. There are, however, certain important exceptions to this general rule.

1. Section 351. Under Section 351, no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.

   a. Control. Under Section 368(c), control means at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.
b. **Boot.** If consideration other than stock is received (boot), gain is recognized but not in excess of the amount of boot received.

2. **Services.** Although Section 351 generally provides for nonrecognition of gain or loss, under Section 351(c), stock issued for services is not treated as issued in exchange for property. Therefore, gain is recognized.

3. **Investment Corporation.** Under Section 351(e), gain or loss is recognized on a transaction which would otherwise qualify for nonrecognition under Section 351 if the corporation is an investment company.

4. **Assumption of Liabilities.** In general, Section 357(a) provides that the assumption of liabilities by a corporation is not treated as a distribution of boot to a shareholder.
   a. **Section 357(c)(1).** Under Section 357(c)(1), a transferor recognizes gain to the extent that the amount of liabilities assumed by the corporation exceeds the taxpayer’s adjusted basis in the assets transferred.
   b. **Section 357(c)(3).** Under Section 357(c), deductible liabilities are disregarded for purposes of determining whether assumed liabilities exceed the transferor’s basis in the transferred assets.

C. **Incorporating an S Corporation.** The tax consequences of forming an S corporation are the same as for C corporations. The only difference is that an S election is filed.

D. **Forming a Partnership.** Under Section 721, no gain or loss is recognized to a partnership or any of its partners upon a transfer to a partnership in exchange for an interest in the partnership.
   1. **Section 721(b).** This rule does not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (under Section 351(e)) if the partnership were incorporated.
   2. **Section 752.** Any decrease in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities is treated as a distribution of money to the partner; any increase in the partner’s share of the liabilities of a partnership is treated as a contribution of money to the partnership by the partner. Thus, if a 10% partner contributes a liability to the partnership, the partner is treated as receiving a distribution
equal to the amount of the liability of which he is relieved. However, this
distribution may be offset by the partner’s share of other liabilities of the
partnership.

a. **Excess Liabilities.** If the liability exceeds the fair market
value of the property, the excess liability is not treated as assumed by
the partnership.

3. **Section 707(a)(2)(B).** If property is transferred to the partnership
and the partner receives distributions from the partnership as a result of that
transfer (usually within 2 years of the date of transfer), then the transfer may
be treated as a disguised sale under the Section 707(a)(2)(B) regulations.

4. **Section 704(c)(2).** If property is contributed by a partner (the
contributing partner) to a partnership and the property is distributed to another
partner within 5 years, then the contributing partner will recognize gain or loss
as if the property had been sold at the time of the distribution, but not in
excess of the amount of gain or loss which would have been realized if the
property had been sold at the time of its contribution.

5. **Section 737.** If property is contributed by a partner to a
partnership and, within 5 years, the contributing partner receives a distribution
of other property from the partnership, then the contributing partner will
recognize gain equal to the lesser of the fair market value of the property
distributed or the amount of gain which would have been realized if the
property had been sold at the time of its contribution.

a. **Previously Contributed Property.** This rule does not apply
if there is a contribution of previously contributed property.

b. **Incorporation.** Beware of the problem which can arise if
a partnership decides to incorporate; the distribution of corporate stock
to a partner who contributed appreciated property within the previous
five years can result in tax consequences, even though there has been
no real change in the business other than an otherwise-nontaxable
incorporation. This problem can be avoided if the partnership is
liquidated, with the partners contributing assets directly to the
corporation.

6. **Other Partnership Rules.** In considering the tax consequences of
the formation of a partnership, it is also necessary to take into account the
provisions concerning the allocation of gain or loss with respect to contributed
property (Section 704(c)) and the rules concerning allocations of income for the year of contribution (Section 706).

E. **Forming a Limited Liability Company.** The tax rules concerning the formation of a limited liability company (LLC) are generally the same as for partnerships (assuming that the LLC qualifies for taxation as a partnership) or, in the rare instances when an LLC will not be treated as a partnership, the same as for C corporations.

II. **TRANSFORMATION**

A. **Changing from C Corporation to S Corporation.** In general, there are no tax consequences when a C corporation elects S status. However, the shareholders must be aware of the tax on built-in gains (the "BIG tax").

1. **Section 1374. The BIG Tax.** Ever since the demise of the General Utilities doctrine brought about by the Tax Reform Act of 1986, tax practitioners have espoused the benefits of the use of the flow-through entity to conduct business operations. Many businesses that were operated as C corporations prior to the 1986 Tax Reform Act elected to become S corporations prior to 1987. Other C corporations may not have elected S corporation status prior to 1987 for various reasons, but due to changed circumstances, have elected S corporation status since 1986.

Congress recognized that an S election offered a C corporation the means to avoid tax on the appreciation in its assets. To address this problem, Congress devised the built-in gains tax (the "BIG tax"), which is imposed on S corporations under Section 1374. The BIG tax of Section 1374 was added to the Code by the Tax Reform Act of 1986.

The following discussion is applicable to a corporation which elects S status after 1986 and which is not subject to the special transitional rules for certain qualified corporations. The BIG tax of Section 1374 does not apply to such a corporation if the S election has been in effect with respect to the corporation for each of its taxable years, except to the extent that the S corporation acquires assets from a C corporation with a carryover basis. In addition, the IRS stated in Announcement 86-128, 1986-51 I.R.B. 22, that it intends to issue regulations which will apply the BIG tax in situations in which an S corporation that is subject to the BIG tax transfers property to another S corporation in a reorganization transaction under Section 368.
a. Newly-Formed Corporations. In the case of a newly-formed corporation, it is very important for the corporation to file the S election within the first 2-1/2 months of the first taxable year of the corporation and for the corporation to qualify as an S corporation from the first day of its first taxable year. See Section 1362(b). Proposed Reg. Section 1.1362-1(c)(3) provides that the taxable year of a new corporation begins on the first date that the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first. If the new corporation fails to qualify as an S corporation from the first day of its first taxable year, then it will be subject to the imposition of the BIG tax.

(i) Inadvertent Termination. An inadvertent termination of S corporation status should not result in the imposition of the BIG tax. Section 1362(c) provides that notwithstanding the terminating event, the corporation is treated as continuing to be an S corporation during the period specified by the Secretary of the Treasury. Therefore, assuming the IRS grants a waiver of the inadvertent termination, the S corporation election is treated as always remaining in effect.

b. Imposition of BIG Tax. Section 1374 imposes a corporate level tax on the "net recognized built-in gain" of an S corporation recognized within the "recognition period." The term "recognition period" means the 10-year period beginning with the first day of the first taxable year for which the corporation was an S corporation.

c. Annual Limitation on the BIG Tax. The term "net recognized built-in gain," as defined in Section 1374(d)(2)(A), serves as an annual limitation on the amount of the built-in gain that maybe subject to tax. This term is defined in Prop. Reg. § 1.1374-2(a) as the least of:

(i) the amount of the taxable income of the S corporation for the taxable year taking into account only the recognized built-in gains, recognized built-in losses, and reorganized built-in gain carryovers, or

(ii) the taxable income of the S corporation for the year determined as if it were a C corporation under Section 63(a) without regard to the deductions provided by Section 172 (net operating losses), Sections 241-247 (the dividends-received deductions), Section 249
(limitations on the deduction of bond premium on repurchase), and Section 250 (certain payments to the national railroad passenger corporation), or

(iii) the amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years.

d. Definitions. The Code defines "recognized built-in gain" as any gain recognized by the corporation during the recognition period on the disposition of any asset except to the extent that the S corporation establishes that:

(i) the asset was not held by the S corporation as of the beginning of the first taxable year for which it was an S corporation, or

(ii) the recognized gain exceeds the amount by which the fair market value of such asset as of the beginning of the first taxable year stated in (i), above, is in excess of the adjusted basis of the asset at such time.

A "recognized built-in loss" is defined as any loss recognized by the S corporation during the recognition period on the disposition of any asset to the extent the S corporation establishes that:

(i) such asset was held by the S corporation as of the beginning of the first taxable year for which it was an S corporation, and

(ii) such loss does not exceed the excess of the adjusted basis of such asset as of the beginning of the taxable year referred to in (i) above, over the fair market value of such asset as of such time.

These definitions are applicable to all of the assets of the S corporation, tangible and intangible, such as patents, know-how and goodwill.

Section 1374(d)(5)(A) provides that "any item of income which is properly taken into account during the recognition period but which is attributable to periods before the first taxable year for which the corporation was an S corporation shall be treated as a recognized built-in gain for the taxable year in which it is properly taken into
Similarly, Section 1374(d)(5)(B) provides that "[a]ny amount which is allowable as a deduction during the recognition period but which is attributable to periods before the first taxable year referred to in subparagraph (a) shall be treated as a recognized built-in loss for the taxable year for which it is allowable as a deduction." These provisions are reflected in Prop. Reg. § 1.1374-4(b).

e. Installment Sales of Assets. In Notice 90-27, 1990-15 I.R.B. 21, the IRS stated that it intends to issue regulations under Sections 337(d) and 1374(e) governing the treatment of installment sales. Section 1374 will apply to income recognized under the installment method during a taxable year ending after the expiration of the recognition period. The Notice indicates that income recognized under the installment method during or after the recognition period from an installment sale of an asset that occurred prior to or during the recognition period will be subject to the BIG tax in an aggregate amount equal to the amount that would have been taxable had the corporation elected out of the installment method under Section 453(d). In computing this amount, the taxable income limitation of Section 1374(d)(2)(A)(ii) and the carryover rule of Section 1374(d)(2)(B) are to be taken into account. The regulations to be issued under this Notice are effective for installment sales occurring on or after March 26, 1990, with certain provisions for binding contracts. This rule is reflected in Prop. Reg. § 1.1374-4(g).

f. Amount of BIG Tax. Under Section 1374(b)(2), the highest rate of tax specified in Section 11(b), currently 35%, is applied to the net recognized built-in gain of the S corporation for the taxable year.

(i) Offset for C Corporation Losses. Under Section 1371(b)(1), an S corporation is generally not permitted to carryover any net operating loss or capital loss from a C corporation to an S corporation taxable year. However, Section 1374(b)(2) permits an S corporation to offset recognized built-in gains with a net operating loss carryover or a capital loss carryover from a C corporation taxable year. See Prop. Reg. § 1.1374-5.

(ii) Offset for C Corporation Tax Credits. Generally, an S corporation is not permitted to utilize tax credit carryovers from C corporation taxable years. However, the S corporation is allowed to offset the BIG tax with a business credit carryforward under Section 39 arising from...
a C corporation taxable year in the same manner as if the BIG tax was imposed by Section 11. Thus, the S corporation will be subject to the same annual limitations imposed on the Section 39 credit under Sections 38 and 39. Similar rules apply in the case of the minimum tax credit under Section 53 attributable to C corporation taxable years. See Prop. Reg. § 1.1374-8.

g. **Acquisition of Assets by an S Corporation from a C Corporation.** Section 1374(d)(8) applies the BIG tax to carryover basis assets acquired by an S corporation if the S corporation’s basis in the assets is determined by reference to the basis of the assets (or other property) in the hands of a C corporation. See Prop. Reg. § 1.1374-8.

(i) **New 10-Year Recognition Period.** The BIG tax applies to the assets acquired by the S corporation for a 10-year period beginning on the day on which the assets were acquired.

(ii) **Applicable To All S Corporations.** Section 1374(d)(8)(B)(ii) provides that this tax is applicable to S corporations, even those S corporations were not previously C corporations and thus not otherwise subject to Section 1374.

2. **Section 1375.** Under Section 1375, if for the taxable year an S corporation has (i) subchapter C earnings and profits at the close of such taxable year, and (ii) gross receipts more than 25 percent of which are passive investment income, then there is imposed a tax on the income of such corporation at the highest corporate rate.

a. **Passive Investment Income.** For purposes of Section 1375, the rules concerning passive investment income are the same as the eligibility rules under Section 1362(d)(3). Under this provision, passive investment income generally includes gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account only to the extent of gains therefrom).

3. **Section 1368.** Section 1368 sets forth the rules concerning taxability of distributions by an S corporation. In the case of a distribution by an S corporation which has accumulated earnings and profits from a prior C year, (i) the portion of the distribution which does not exceed the accumulated adjustments account (generally, undistributed profits) is generally treated as
nontaxable, (ii) the portion of the distribution which remains is treated as a taxable dividend to the extent that it does not exceed the amount of the accumulated earnings and profits of the former C corporation, and (iii) the remainder is treated as a return of basis and, then, gain from the sale or exchange of property.

4. **LIFO Recapture.** If a C corporation inventoried goods under the LIFO method for the last taxable year before which an S election applies, then the corporation is generally required to treat the LIFO recapture amount as income, although the tax increase may be spread over 4 years.

5. **Carryovers.** Under Section 1371(b)(1), no carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation.

6. **Investment Credit Recapture.** Under Section 1371(d)(1), an election to be an S corporation under Section 1362 is treated as a mere change in the form of doing business and does not result in investment credit recapture.

B. **Changing from S Corporation to C Corporation.** When an S corporation election is terminated, there are no direct tax consequences. However, the termination of the election will close the taxable year of the S corporation. In addition, consideration must be given to the rules concerning the use of losses in the post-termination transition period.

1. **Section 1366(d)(3).** Under this provision, if for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed as a result of the basis limitation in Section 1366(d)(1), then such loss or deduction is treated as incurred by the shareholder on the last day of any post-termination transaction period.

   a. **Practical Effect.** In other words, a shareholder is permitted to use the suspended loss if the shareholder's basis in stock of the corporation is increased during the post-termination transaction period.

   2. **Section 1371(e).** Under this provision, any cash distribution from a corporation during the post-termination transition period is treated as a return of basis (and not a taxable dividend) to the extent that the amount of the distribution does not exceed the accumulated adjustments account of the former S corporation (within the meaning of Section 1368(e)).
a. **Election.** An S corporation may elect that a distribution during the post-termination transition period not be treated as a return of basis. This election would likely be made only if the shareholders had expiring losses or were corporations eligible for the dividends-received deduction.

3. **Post-termination transition period.** In general, under Section 1377(b)(1)(A), the post-termination transition period means the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of (i) the day which is 1 year after such last day, or (ii) the due date for filing the return for such last year as an S corporation (including extensions).

   a. **Practical Effect.** Thus, shareholders of a former S corporation have one year to increase basis in order to take advantage of suspended pre-termination losses.

4. **Carryovers.** Under Section 1371(b)(2), no carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a former C corporation is an S corporation.

C. **Changing from Partnership to C Corporation.** In general, the incorporation of a partnership is subject to the same general rules concerning the incorporation of any other business, i.e., in general, such transaction is nontaxable under Section 351. There are three different ways in which a partnership can be incorporated; under Rev. Rul. 84-111, 1984-2 C.B. 88, the form of the incorporation is given tax substance.

   1. **Transfer of Assets to a C Corporation.** The partnership could transfer all of its assets to a C corporation and then, upon receipt of stock in the C corporation, the partnership could liquidate and transfer the stock to its partners. In this transaction, the C corporation takes over the basis which the partnership had in its assets, and the partners (now shareholders) have a carryover basis to the stock equal to their basis in their partnership interests.

   2. **Transfer of Partnership Interests to a C Corporation.** The partners could individually transfer their interests in the partnership to the C corporation. As a result of the acquisition of all of the interests in the partnership, the partnership would automatically liquidate, and the C corporation would directly own the assets formerly owned by the partnership. The C corporation would have a basis in the assets equal to the basis of the former partners in their partnership interests, and the partners would have a carryover basis to the stock equal to their basis in their partnership interests.
3. **Liquidation, then Incorporation.** The partnership could be liquidated, which generally is nontaxable under Section 731. The partners could then transfer assets directly to the C corporation. In general, this approach would give the C corporation a basis in its assets equal to the basis which the partners had in their partnership interests. This approach can result in recognition of gain to a partner if the amount of cash received upon liquidation exceeds the partner's basis in his partnership interest.

D. **Changing from Partnership to S Corporation.** The tax consequences of changing from a partnership to an S corporation are the same as apply in changing from a partnership to a C corporation.

E. **Changing from C Corporation to Partnership.** Changing from a C corporation to a partnership generally involves the liquidation of a corporation. A liquidation is generally fully taxable to the shareholder and, pursuant to the repeal of General Utilities, to the corporation as well.

1. **Effect of Distribution of Appreciated Property.** If, as part of conversion to a partnership, a C corporation distributes appreciated property to its shareholders, the C corporation will recognize gain as will the shareholder. If the corporation is subject to a 35% tax rate and the shareholder a 28% tax rate, the effective tax rate on the distribution is 53.2%, without regard to state and local taxes. In the event that the distribution is treated as a dividend taxable at the ordinary income rate of 39%, then the combined effective tax rate on the distribution is 60.35% (again, without consideration for state and local taxes).

2. **Alternatives.** Set forth below are various alternative transactions to avoid the high effective tax rates when a corporation liquidates.

F. **Changing from S Corporation to Partnership.** The liquidation of an S corporation is also a taxable event to the corporation and its shareholders under the general rules that apply to C corporations. Although it is "common wisdom" that an S corporation is a passthrough entity and not subject to taxation, this is true only if the assets of the S corporation are sold immediately after the liquidation, in which case there is one level of tax.

1. **Tax on Liquidation.** Assume that an S corporation owns only a single asset with a basis of $0 and a fair market value of $100; also assume that the sole shareholder has a $0 basis in his stock. If the S corporation is liquidated, the corporation has $100 of gain which flows through to the shareholder, who increases his basis in his stock to $100. When the S corporation distributes assets, the shareholder now has a "stepped up" basis
to $100, so he does not pay any tax on the distribution. If the shareholder then sells the asset for $100, he has $100 of cash and owes only tax on the $100 of gain which was recognized by the S corporation upon the distribution of appreciated property. Thus, the shareholder pays only one level of tax (presumably at a 28% rate on capital gains).

2. **Tax on Contribution.** Assume the same facts as set forth above, except the shareholder transfers the asset to a partnership instead of selling it for its fair market value of $100. However, the shareholder has recognized $100 of gain as a result of the liquidation and he will have to pay tax on this gain. If the shareholder transfers the asset to a partnership, he will have the tax liability but no cash to pay the IRS.

G. **Changing from LLC to a Corporation.** The rules are the same as apply to the liquidation of a partnership.

H. **Changing from LLC to a Partnership.** The transfer of the assets of an LLC to a partnership is generally nontaxable under Section 721 and the other rules which apply to the formation of a partnership.

1. **LLC as Partner.** In many situations, the LLC will transfer its assets directly to the partnership and the LLC will then liquidate so that the former members of the LLC are direct partners in the partnership. However, it is possible that the LLC will remain in existence and serve as a partner in the partnership, thereby providing a limitation on liability to the members of the LLC. Of course, the LLC cannot be the only partner in the partnership; a partnership must have more than one partner.

2. **Rev. Rul. 84-111.** Other methods by which an LLC can form a partnership include (i) liquidation of the LLC, or (ii) transfer of interests in an LLC to a partnership. Although the IRS has not yet addressed whether the method of formation of a partnership by an LLC will be given tax effect, by analogy to Rev. Rul. 84-111 it seems likely that the form of the transaction will be controlling.

I. **Changing from Corporation to LLC.** In order to change a corporation into an LLC, the corporation must be liquidated. Thus, the rules discussed above concerning the liquidation of a corporation are applicable.

J. **Changing from Partnership to LLC.** Generally, the transfer of assets of a partnership to an LLC, or the transfer of partnership interests to an LLC in exchange for interests in the LLC, is a nontaxable transaction under the rules which govern the formation of a partnership (particularly Section 721). However, in the
former situation the partnership will remain "alive" as the holder of interests in the LLC unless the partnership is liquidated (which is also a nontaxable transaction). In contrast, in the latter situation in which partnership interests are transferred to an LLC in exchange for interests in the LLC, the partnership will automatically terminate because it will only have one partner. Finally, it is possible that the partnership could be liquidated, with assets then being contributed directly by the partners to the LLC.

1. **Rev. Rul. 84-111.** Although the IRS has not yet addressed whether the method of formation of an LLC by a partnership will be given tax effect, by analogy to Rev. Rul. 84-111 it seems likely that the form of the transaction will be controlling.

### III. CHANGING WITHOUT TRANSFORMATION

#### A. Freezing C Corporation Businesses through Partnerships

One of the most common techniques used to change from a corporate to a pass-through form of operation involves a "freezed" transactions. These transactions were pioneered in the estate planning context, but they have lost much of their attractiveness in that area due to the enactment of the special rules in Chapter 14. However, the underlying technique used in estate freezes can also be used between unrelated persons who wish to limit the amount of income or gain subject to double taxation through a C corporation.

1. **Basic Structure of a "Freeze" Transaction.** In a typical "freeze" transaction, a C corporation will transfer assets to a partnership in which its shareholders (and perhaps additional persons) are partners in exchange for a preferred interest in the partnership. This preferred interest will usually have a stated value but no (or only a minimal) interest in the future income and growth of the business, and frequently will be redeemable by the partnership for an amount equal to fair market value at the time of the contribution. The other partners will contribute cash to the partnership in exchange for all of the common interests in the partnership. Each partner will receive an initial capital account equal to the fair market value of its contribution; an outside appraisal is usually made.

   a. **Practical Effect.** The effect of the freeze transaction is that future income and appreciation are passed through to the "common" interests; the preferred interest does not appreciate in value except to an insubstantial extent. However, any appreciation which arose before the transaction is consummated will be taxable to the corporation alone.
2. **Example.** Assume that Oldcorp is a C corporation owned by two unrelated shareholders, Tom and Anne, and that Oldcorp owns property which is expected to generate significant income and also appreciate in value. At the present time, the fair market value of the assets of Oldcorp, less its liabilities, is $5 million and the tax basis of such assets is $0; Oldcorp has annual profits of $500,000 per year. In order to avoid future double taxation to the extent possible, all of the assets and liabilities of Oldcorp are transferred to a partnership, Newco, in exchange for a preferred interest in Newco. Tom and Anne each contribute $250,000 to Newco in exchange for 50% interests each. The preferred interest received by Oldcorp is entitled to a preference on liquidation as well as a preferred return of 3% on the undistributed capital account.

   a. **Treatment of Operating Income.** In this example, the preferred return would require that $150,000 per year of the income of Newco be allocated to Oldcorp. The balance of the income ($350,000 per year) would be divided equally between Tom and Anne. Assuming that the $350,000 would otherwise be income to Oldcorp which would then distribute its after tax profits to Tom and Anne as a dividend, the effect of this structure is to reduce the tax on $350,000 of the income from over 60% to 39%; the remaining $150,000 of income is still subject to double taxation.

   b. **Treatment of Appreciation.** Further assume that after 3 more years, the assets of Newco are sold for $10 million; all of the gain is capital gain. On liquidation, $5 million of gain is allocated to Oldcorp, and the effective tax liability on this $5 million is 53.2% of the gain, so that Tom and Anne would receive $2,340,000 through Oldcorp. In contrast, the $5 million of gain allocated to Tom and Anne directly by Newco would be subject to taxation at a 28% rate, so they would receive $3,600,000 directly from the partnership.

B. **Freezing C Corporation Businesses through Subsidiaries.** An alternative type of "freeze" transaction uses a subsidiary corporation instead of a partnership. In this type of transaction, preferred stock is given to the contributing corporation, and the common stock of the subsidiary is given to the persons who are to own the appreciation plus income in excess of the preferred return, if any, on the preferred stock.

   1. **Advantage.** The subsidiary freeze moves the ownership of appreciation from one C corporation to another, which can be a useful way to address dividends and long-term versus short-term shareholders.
2. **Disadvantage.** Because the use of a C corporation subsidiary does not permit pass-through treatment, it often does not result in tax savings. The tax savings, if any, which are realized will more often arise when one shareholder is a corporation which can take advantage of the dividends received deduction; the use of a special subsidiary can result in dividends being paid to the shareholder who can take advantage of them.

3. **S corporations.** The subsidiary freeze cannot utilize an S corporation because of the prohibition against corporate shareholders.

**C. Freezing S Corporation Businesses through Partnerships.** A freeze involving an S corporation can be structured in the same manner as a freeze with a C corporation. However, because of the pass-through nature of an S corporation, the freeze transaction is usually not as productive (or necessary).

1. **Rev. Rul. 77-220.** One of the concerns which must be addressed when an S corporation is a partner in a partnership is whether the partnership is a device used to avoid the limitation on the number or type of shareholders of the S corporation. In Rev. Rul. 77-220, 1977-1 C.B. 263, a single business operated by 30 persons was transferred to a partnership in which the partners were three separate S corporation, each of which had the 10 shareholders then permitted for an S corporation. The IRS viewed this as a device to avoid the limitations on S corporation shareholders.

2. **Passive Income.** If an S corporation has a passive income problem, the use of a partnership in which the passive income is allocated to other partners may be a way to minimize the problem, provided that the allocation of the passive income has substantial economic effect under the Section 704(b) regulations.

3. **BIG Tax.** Can an S corporation with built-in gain attempt to avoid that gain by transferring the assets to a partnership? Probably not because any gain on the sale of the assets would have to be allocated to the contributing partner (the S corporation) under Section 704(c). Thus, when the assets are sold, the S corporation would have the income and have to pay the BIG tax.

**D. Freezing S Corporation Businesses through Subsidiaries.** An S corporation cannot have a subsidiary in which it owns 80% or more of the stock. However, an S corporation can own less than 80% of the stock of a corporation. Thus, it is possible for an S corporation to enter into a "freeze" transaction involving a corporate subsidiary. However, there usually is very little tax advantage to this type of transaction except that the income of C corporations which retain ther
income will now be subject to lower rates than S corporation income; this rate differential may make C corporation freezes attractive in some situations.

E. **Freezing Partnership Businesses through Tiers.** There are a number of ways that a partnership can be used to "freeze" an ownership interest. The easiest way often involves the creation of a preferred interest as discussed above. Instead, multiple tiers can be created, with the income being allocated on the basis of the ownership interest in each lower tier.

1. **Example.** Assume that Opco is a partnership in which two corporations, X and Y, are partners. The shareholders of X and Y want to do a "freeze" transaction but they don't want to create a preferred interest. Instead, the assets of Opco are transferred to Newco, a partnership between Opco and the shareholders of Opco. Through income allocations, the shareholders are able to avoid the income of Opco going through its corporate shareholders.

F. **Freezing Partnership Businesses through C Corporations.** Theoretically, a partnership could become the shareholder in a C corporation to engineer a "freeze" transaction in which income of the partnership is effectively shifted to the C corporation. Although this approach is unusual, it may be desirable if the partnership needs to retain income and wants to pay tax at the lowest possible current rate. In light of the spread between individual tax rates and corporate rates, the transfer of income to the corporation may be advantageous in some situations.

G. **Freezing LLCs.** The rules for freezes involving LLCs are the same as those for partnerships.

IV. **DIVISIVE CHANGES**

In many situations, taxpayers will want to transform a business as part of, or in conjunction with, the division of a business. This situation arises most frequently when there is an inter-generational transfer or a dispute among the owners.

A. **Spinoffs by C Corporations.** A C corporation can make a nontaxable spin-off if the requirements of Section 355 are satisfied.

1. **In General.** In general, Section 355 imposes the following requirements: (i) a corporation (the "distributing corporation") distributes to a shareholder, with respect to its stock, solely stock or securities of a corporation (the "controlled corporation") which the distributing corporation controls immediately before the distribution; (ii) the transaction was not
used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both; (iii) there is a business purpose for the distribution; (iv) the active business requirement of Section 355(b) is satisfied; and (v) as part of the distribution, the distributing corporation distributes stock which constitutes control of the controlled corporation. A detailed explanation of Section 355 is beyond the scope of this outline.

2. Transformation combined with Spinoff. In many situations, a shareholder of a C corporation will want to make an S election after the spinoff under Section 355. The issue which arises is whether the S election indicates that there was a valid business purpose for the distribution. Under the regulations, a shareholder purpose is not treated as a valid corporate business purpose. Reg. § 1.355-2(b)(2).

   a. S elections. The regulations make clear that a spinoff which is made for the purpose of enabling a corporation to make an S election does not have a valid corporate business purpose. Reg. § 1.355-2(b)(5), Example (6).

   b. State S election. Likewise, a spinoff which is made to permit an S election to be made for state tax purposes does not have a valid business purpose. Reg. § 1.355-2(b)(5), Example (7).

   c. IRS Ruling Position. If a ruling is sought with respect to a Section 355 spinoff, the IRS will usually seek a representation that an S election will not be made for at period of time.

3. Spinoff Combined with Other Changes. Although an S election cannot be made after a spinoff by a C corporation, the IRS has never addressed whether other types of transactions, such as a partnership freeze, could not be combined with a spinoff. However, a proper business purpose is still required for the spinoff.

B. Spinoffs by S Corporations. For purposes of determining whether a spinoff by an S corporation is allowed, the general rules of Section 355, discussed above, are applicable. Thus, all of the requirements of Section 355 must be satisfied in order for an S corporation to make a spinoff.

   1. Loss of S Status. A spinoff under Section 355 requires that the distributing corporation control the controlled corporation immediately before the spinoff. However, under Section 1361(b)(2), an S corporation cannot be a member of an affiliated group, i.e., the S corporation cannot have a
controlled subsidiary. Will the formation of the subsidiary that is to be spun off destroy the S election?

a. IRS Rulings. In a number of rulings, the IRS has recognized that the merely transitory ownership of another corporation by an S corporation should be disregarded for purposes of determining whether the S corporation retains its S status.

2. Section 1371(a)(2). Under Section 1371(a)(2), for purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation is treated as an individual. Some commentators have noted that this provision would make it impossible for an S corporation to engage in a Section 355 spinoff because, at the instant in time when the distributing S corporation owns stock of the controlled corporation, the S corporation should be viewed as an individual and, hence, ineligible for Section 355.

a. IRS Rulings. Again, the IRS has not applied Section 1371(a)(2) literally but, rather, has permitted S corporations to engage in Section 355 spinoffs.

b. Technical Correction. The proposed technical corrections legislation which was introduced in January 1993 by Chairman Rostenkowski would solve this problem by clarifying that an S corporation could own subsidiaries and would be treated as a corporation for purposes of Section 355.

3. S Election and Business Purpose. As discussed above, a spinoff cannot be made by a C corporation in order to enable the corporation to make an S election. Furthermore, for rulings purposes, the IRS will not rule favorably unless the corporation represents that it will not make an S election. In contrast, in the case of an S corporation, there is no "bad purpose" if the spun-off corporation makes an S election. The IRS apparently justifies this conclusion because there is no net change, i.e., both the distributing corporation and the controlled corporation were S corporations before and after the transaction.

C. Spinoffs by Partnerships. There are very few practical difficulties in a partnership entering into a transaction which results in a "spinoff" of a portion of the partnership. Specifically, a partnership can transfer a portion of its assets to another partnership in a transaction which is nontaxable under Section 721, and the distribution of the partnership interest to one or more partners is generally nontaxable under Section 731.
1. **More than One Partner.** A corporation can form a wholly-owned subsidiary. In contrast, a partnership exists only if there is more than one partner. As a result, in order to do a partnership spinoff, an accommodation partner is often needed.

2. **Liabilities.** When a distribution of a partnership interest is made, the result may be a reduction in the liabilities which are allocated to the various partners. Care must be taken to make certain that the partners do not receive a deemed distribution under Section 752 which is taxable under Section 731.

3. **Section 737.** Section 737 applies whenever a partner contributes appreciated property to a partnership and, within 5 years, receives a distribution of property, other than the contributed property, from the partnership. Section 737 does not provide that a distribution of an interest in a pass-through or other entity which owns the contributed property. Thus, even though the contributing partner could receive a distribution of the contributed property, it is questionable whether the distributing partner could receive a distribution of an interest in a partnership which owns the contributed property.

   a. **Example.** Patricia contributes appreciated land to partnership PQRST. After a falling out with Ron, Steve and Tom, Patricia and Quincy demand that property they contributed be transferred to a new partnership, PQ, and that the interests in PQ then be distributed to them. It is possible that the distribution of the interest in PQ to Patricia within 5 years of the initial transfer to PQRST could result in the recognition of gain by Patricia under Section 737.

4. **Section 708(b)(2).** Under this provision, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall be considered a continuation of the prior partnership.

   a. **Practical Effect.** If a partnership’s assets are split up among new partnerships pro rata, with each partner owning an interest in all of the new partnerships, there is no termination of the partnership. On the other hand, if the assets of a partnership are divided between the partners, then the partnership which is received by the "minority" partners will not be treated as a continuation of the prior partnership. If there is a 50-50 split, so that the members of none of the resulting partnerships owned a more than 50 percent interest into the divided
partnership, then the divided partnership is terminated. Reg. § 1.708-1(b)(2)(ii).

5. **Section 708(b)(1).** Will a distribution of all of the capital and profits interests in a partnership constitute a termination of that partnership under Section 708(b)(1)? This problem could arise if there is an exchange (i.e., a redemption) but not if there is merely a distribution without a sale or exchange. Although Section 708(b)(2) implies that the distribution will not result in a termination, there is no direct coordination between Sections 708(b)(1) and 708(b)(2).

6. **Other Collateral Problems.** Other provisions in the Code concerning partnership taxation which are affected by a transfer of a partnership interest and the retirement of a partner (e.g., Sections 706, 734, 736 and 751) must be considered whenever there is a distribution of interests in a partnership.

D. **Spinoffs by LLCs.** The rules concerning spinoffs by LLCs are the same as the rules for partnerships.

V. **CHANGES BY COMBINATION**

In addition to spinning off entities as part of a transformation, it also is possible to combine entities. Various types of mergers, reorganizations and similar transactions can be used as part of the conversion from one type of an entity to another.

A. **Mergers of C Corporations.** In general, a merger of C corporations is a nontaxable reorganization described in Section 368(a)(1)(A). However, the mere merger of two C corporations does not result in a change in the type of entity; instead, a merger simply combines two C corporations into a single C corporation.

B. **Merger of C and S Corporations.** A C corporation and an S corporation could be combined by merger, with one corporation or the other surviving.

1. **Section 1371(a)(2).** The issue which arises is whether Section 1371(a)(2) somehow prohibits an S corporation from merging with a C corporation. However, this provision only addresses stock held by an S corporation, so that in most situations the rule should not affect the validity of the merger of an S corporation and a C corporation.
2. **Which One Survives?** There is no requirement that either the S corporation or the C corporation be the corporation which survives the merger; apparently, the matter can be decided by the shareholders. Thus, either the S corporation or the C corporation can be the surviving corporation.

   a. **Business Reality.** In most situations, the determination as to which corporation is the surviving corporation will be made for business reasons, usually relating to the liabilities of the corporations.

   b. **Same as Election.** Although it is somewhat remarkable that either the S corporation or the C corporation could survive, this is consistent with the ability of the shareholders of a C corporation to elect S status, and vice versa.

   c. **Device to Avoid Election Requirement?** Assume that an S corporation’s election has terminated and it wants to re-elect S status within 5 years. Under Section 1362(g), the corporation and any successor corporation is not permitted to make an S election within 5 years without the consent of the IRS.

      (i) **Successor Corporation Defined.** Under Reg. § 1.1362-5(b), a corporation is the successor to a corporation whose election has been terminated if (1) 50 percent or more of the stock of the corporation (the new corporation) is owned, directly or indirectly, by the same persons who, on the date of the termination, owned 50 percent or more of the stock of the corporation whose election terminated (the old corporation); and (2) either the new corporation acquires a substantial portion of the assets of the old corporation, or a substantial portion of the assets of the new corporation were assets of the old corporation.

      (ii) **Effect of Definition.** The regulations which define a successor corporation do not indicate whether the phrase "directly or indirectly" relates to attribution or merely indirect ownership (for example, through a pass-through entity). Likewise, the 50 percent test provides an opportunity in situations in which there will be a change of ownership to elect S status.

      (a) **Example.** Oldco was an S corporation but its election was terminated in 1995. John wants to purchase the stock of Oldco but he also wants to make an S election. To address this problem, Oldco is acquired
through a merger with an S corporation (Newco) which is more than 50% owned by John, with Newco surviving. Apparently Newco will not be barred from maintaining its S status under the successor rules.

C. **Other Types of Reorganizations.** A merger is not the only type of nontaxable transaction which can be used by a C corporation to change its form. Reorganizations under Section 368(a)(1)(C) (transfer of all or substantially all of the assets of a corporation in exchange for stock) or Section 368(a)(1)(D) (transfer of assets to certain controlled corporations) can also be utilized to transfer assets or a business to another corporation and, in the course of the transaction, change from C to S status, or vice versa.

D. **Mergers of Corporations and Partnerships.** This can’t be done on a nontaxable basis. The transaction will be recharacterized as a liquidation of the non-surviving entity, followed by a contribution to the surviving entity.

E. **Mergers by Partnerships.** A partnership merger will usually not be used in order to transform an entity. If a merger of two or more partnerships is part of a transaction, the resulting partnership will be considered a continuation of the mergering or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership; any other merging or consolidating partnership is terminated. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of merged or consolidated partnerships are terminated and a new partnership results. Reg. § 1.708-1(b)(2)(i).

1. **Effect.** The continuing partnership, if any, must disclose on its tax return that it is the continuation of merging or consolidating partnerships. The taxable years of the merging or consolidating partnerships which are considered terminated are closed in accordance with Section 706(c) and those partnerships must file final returns. Id.

F. **LLC Mergers.** Generally, the same tax rules apply to LLC mergers as apply to partnership mergers. However, attention must be paid to the applicable state LLC law in order to determine when and how an LLC can merge with any other entity.

VI. **CHANGES WITHOUT EQUITY**

The foregoing transactions have all involved the equity of a business. There are ways to effectively "transform" the character of an entity without using equity.
A. **Debt Freezes.** There are several ways in which debt can be used effectively to transform the nature of an entity, even if no change is made to the entity itself.

1. **Sale.** One of the simplest ways to change an entity is through a sale. The sale of the assets of a C corporation to its shareholders can give the shareholders the ability to receive future appreciation without any risk of double taxation. Depending upon the amount of appreciation at the time of the sale, the tax consequences of the transaction may be minimal.

   a. **Loss Disallowance.** Any time a sale to a shareholder is contemplated, consideration must be given to the loss disallowance rules in Section 267.

2. **Straight Debt.** In many situations, the shareholders will not want to sell the assets of a C corporation because of the tax consequences. However, a significant portion of future income can be removed from double taxation through debt. If the C corporation borrows money from its shareholders, the interest will be deductible. If this interest "soaks up" a significant portion of the future income of the corporation, the effect is to remove this income from double taxation.

   a. **Limit on Interest Rate.** The Code does not contain any maximum interest rates. However, if the interest rate on a debt instrument is too high, the instrument could be viewed as equity for tax purposes.

3. **Participating or Contingent Debt.** Another means to "soak up" the income or appreciation of a C corporation involves participating or contingent debt. The debt instrument will provide for fixed interest plus additional interest based upon the cash flow and/or appreciation in value of the assets of the corporation. Because the interest will be deducted by the C corporation and will be subject only to a single level of taxation in the hands of the shareholder, the effect is to eliminate double taxation. Participating or contingent interest is particularly useful if the C corporation has appreciating assets and the shareholders want to shift some of that appreciation outside of the corporation.

   a. **Yield Cap.** In order to avoid potential recharacterization of the instrument as equity, a "yield cap" which limits the maximum internal rate of return to a "market" rate, taking into account the risk, is strongly advised.
4. **Other Limitations on Debt.** If debt is going to be used to move value out of a C corporation, consideration must be given to the rules limiting interest deductions under Sections 163(e)(5) (applicable high yield debt obligations) and 163(j) (earnings stripping).

B. **Employment Agreements.** Another means to move the income from a C corporation to its shareholders is through employment agreements. The purpose of the agreements is to reduce the amount of corporate income which is subject to double taxation to the maximum extent possible. However, in order to achieve the desired benefit, salaries cannot be unreasonable.

VII. **THE LAST ACT**

The final type of "change" which can occur in the life cycle of a business is when it returns to its roots, i.e., the business is liquidated. Just as the formation of a business can have tax consequences, there also can be tax consequences upon liquidation.

A. **Liquidation of a C Corporation.** In general, when a C corporation is liquidated there is double taxation: first, to the C corporation to the extent that the fair market value of its assets exceeds its adjusted basis in those assets, and second, to the shareholders, to the extent that the amount which they receive upon liquidation.

1. **Section 336.** Under Section 336(a), except as otherwise provided in Section 336 or Section 337, gain or loss is recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value. Under Section 336(b), if any property distributed in the liquidation is subject to a liability or the shareholder assumes a liability of the liquidating corporation in connection with the distribution, the fair market value of the property is treated as not less than the amount of such liability.

   a. **Practical Effect.** The practical effect of Section 336 is that the corporation recognizes any gain inherent in property distributed in complete liquidation. This provision overrules the General Utilities doctrine under which appreciated property could be distributed by a corporation in complete liquidation without any adverse tax consequences at the corporate level.

   b. **Reorganizations.** This general rule does not apply in the cases of liquidations which are part of a reorganization.
2. **Section 331.** Under Section 331, amounts received by a shareholder in a distribution in complete liquidation of a corporation are treated as in full payment in exchange for the stock of the corporation. The rules in Section 301 concerning the tax treatment of dividends are inapplicable to distributions in complete liquidation of a corporation.

   a. **Practical Effect.** The practical effect of this provision is that the shareholder is taxed on the amount received in a complete liquidation as if the shareholder had sold his stock. Thus, the gain is equal to the amount of the gross receipts received by the shareholder less his or her adjusted basis in the stock of the corporation.

   b. **Example.** Newco has assets with a fair market value of $100 and an adjusted basis of $0; the shareholder’s basis in the stock of Newco is also $0. If the property is distributed to the shareholder in complete liquidation of Newco, the corporation will recognize gain of $100 on which it will have to pay Federal income tax (at the 35% rate) of $35. The remaining $65 will then be distributed to the shareholder who will need to pay an additional tax (at a 28% rate) of $18.20. Thus, the total Federal income tax paid on the distribution would be $53.20. If the shareholder does not qualify for long term capital gains treatment on the distribution, the total Federal income tax on the liquidation would increase to $60.45 at the 39% marginal rate. Additional state and local taxes could further reduce the net after-tax proceeds available to the shareholder.

3. **Sections 337 and 332.** In general, under Sections 337 and 332, no gain or loss is recognized by a liquidating corporation or its controlling corporate shareholder. This rule applies only if the corporate shareholder owns 80% of the vote and value of the stock of the liquidating corporation (other than certain preferred stock which is not taken into account).

4. **Additional Information.** A detailed discussion of the tax treatment of corporate liquidations is beyond the scope of this outline. See Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders.*

B. **Liquidation of S Corporations.** The rules which apply to the liquidation of C corporations also apply to S corporation liquidations. Thus, under Section 336 the corporation is subject to tax to the extent that the fair market value of distributed property exceeds its adjusted basis, and the shareholder is subject to tax to the extent that the amount received on liquidation exceeds his or her adjusted
basis in the stock of the S corporation. As a practical matter, however, the flow-through treatment of income effectively eliminates the second level of tax.

1. Example. Assume the same facts as in the example above, except that Newco is an S corporation. In that event, Newco would have $100 of gain upon the sale of its assets, which would require its shareholder to pay $28 of tax. However, the gain would result in a basis increase of the corporate stock in the hands of the shareholder of $100. Thus, when the corporation distributes property worth $100 to the shareholder, no additional tax will be due.

   a. Amount Distributed. Note that in the case of a C corporation only $65 was available for distribution because of the tax liability at the corporate level. In the case of an S corporation, however, the distribution is equal to the full fair market value of the property of the S corporation, i.e., in this example, $100.

C. Liquidation of a Partnership. Unlike a corporate liquidation, the liquidation of a partnership is generally not a taxable transaction.

   1. Section 731. Subject to the exceptions in Section 731(c), under Section 731(a), in the case of a distribution by a partnership to a partner, gain is not recognized except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and loss is not recognized except upon a distribution in liquidation in a partnership where no property other than money and unrealized receivables is distributed. Under Section 731(b), no gain or loss is recognized to a partnership on a distribution to a partner of property, including money.

   a. Exceptions. Under Sections 731(c), the general rule for nonrecognition in Section 731 does not apply to the extent otherwise provided in Sections 736, 751 and 737.

      (i) Section 736. Section 736(a) addresses the tax treatment of payments made by a partnership in liquidation of the interest of a retiring or deceased partner. A discussion of this provision is beyond the scope of this outline.

      (ii) Section 751. Under Section 751, the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to unrealized receivables or appreciated inventory is considered as an amount realized from
the sale or exchange of property other than a capital asset. A detailed discussion of this provision is beyond the scope of this outline.

(iii) **Section 737.** Under Section 737, if appreciated property is contributed by a partner to a partnership and other property is distributed by the partnership to the partner within 5 years, gain is recognized by the partner up to the amount of the gain inherent in the contributed property at the time of contribution. This provision applies even if the partner receives a distribution upon complete liquidation of the partnership.

2. **Basis.** Under Section 732(b), the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner’s interest is equal to the adjusted basis of such partner’s interest in the partnership reduced by any money distributed in the same transaction.

D. **Liquidation of an LLC.** The rules involving liquidations of LLCs are generally the same as for liquidation of partnerships.

**CONCLUSION**

There are many changes which can occur during the life cycle of a business. A taxpayer who is aware of the tax effects of these changes will be able to minimize the tax consequences of the changes when they occur. In addition, in a number of instances taxpayers can use alternative transactions (such as freezes) to receive some or all of the benefits of changing the type of entity without triggering the adverse tax consequences which usually accompany such a change.