Conversion of Regular Corporation to Pass-Through Entity

Peter L. Faber

Repository Citation

Copyright c 1987 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository. https://scholarship.law.wm.edu/tax
CONVERSION OF REGULAR CORPORATION TO PASS-THROUGH ENTITY

By

Peter L. Faber

I. Conversion to S Corporation

A. Reorganizing the corporation to qualify for S status

1. The corporation may not have more than 35 shareholders. I.R.C. § 1361(b)(1)(A).

   a. If the corporation has more than 35 shareholders, the corporation and/or the controlling shareholders may approach some shareholders to buy them out.

      (1) If the corporation buys them out in a redemption, the redemption may be treated as a dividend if it does not substantially reduce their proportionate interests in the corporation, taking into account certain constructive ownership rules. I.R.C. §§ 302, 318. This is not a problem if the buyout is made by other shareholders.

      (2) The number of shareholders may be reduced by gifts. There are no constructive ownership rules in applying the 35 shareholder test.

   b. Minority shareholders can be forced out if the controlling shareholders form a new corporation that merges with the old corporation for cash.

2. The corporation may not have a shareholder who is not an individual, an estate, or a certain type of trust. I.R.C. § 1361(b)(1)(B).

   a. Shareholders should be advised about prohibitions

      (1) Shareholders may be planning transfers to trusts in connection with family and estate planning. They should be advised about requirements for permitted trusts.

      (2) Shareholders may be planning transfers to corporations or partnerships in connection with estate freezes.

   b. Prohibited shareholders may be bought out

      (1) See the discussion under I.A.1. above relating to techniques and tax problems.

      (2) Fiduciaries may have problems relating to the fairness and allocation of sales price.
c. Shareholders holding stock through partnerships or corporations for convenience may liquidate the holding entities.

(1) The liquidation of a partnership will ordinarily not be a taxable event unless cash is distributed. I.R.C. § 731(a).

(2) The liquidation of a corporation will ordinarily be taxable to both the corporation and to the shareholders. I.R.C. § 333 has been repealed, subject to the small business transitional rule of the Tax Reform Act of 1986. The phase-out of the small business exception causes gain recognition to the liquidating corporation, which increases earnings and profits. TRA 1986 §§ 631(e)(3); 633(d)(1); Rev. Rul. 87-4, I.R.B. 1987-2,8. Section 333 did not apply, in any event, to the receipt of stock or securities.

d. Purported debt of the corporation held by corporate or partnership lenders should be examined to make sure that it is not stock.

(1) Debt with an interest in corporate growth may be held to be stock in part. Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960). Lenders in leveraged buyouts often take equity-flavored debt.

(2) Convertible debt and warrants should not be held to be stock until they are converted or exercised. Rev. Rul. 67-269, 1967-2 C.B. 298.

(3) The safe harbor that protects debt from being treated as a second class of stock for purposes of the one-class-of-stock rule of I.R.C. § 1361(b)(1)(D) does not protect it from being treated as stock for purposes of I.R.C. § 1361(b)(1)(B). I.R.C. § 1361(c)(5).


3. The corporation may not have a shareholder who is a nonresident alien. I.R.C. § 1361(b)(1)(C).

a. Buying back the stock of a nonresident alien (see I.A.1. above) may present special problems.

(1) The shareholder may not be taxed on capital gain realized on the sale. I.R.C. § 871(a)(2). See applicable treaty provisions.

(2) Redemption proceeds treated as a dividend may be subject to withholding of income tax at 30% or the applicable treaty rate. I.R.C. § 1441.

b. Foreign shareholders are sometimes employees of foreign operations if the corporation has a partially-owned (i.e., less than 80%) foreign subsidiary, one possibility would be to give foreign employees stock in the subsidiary. Another possibility would be to use equity-flavored compensation (e.g., bonus or deferred compensation keyed to performance of the company).
4. The corporation may not have more than one class of stock. I.R.C. § 1361(b)(1)(D).

a. The corporation may previously have created a class of preferred stock in connection with an estate freeze.

(1) The corporation may recapitalize, converting the preferred stock back into common stock. I.R.C. § 368(a)(1)(E).

(a) This ends the freeze, recreating the estate planning problem that led to it.

(b) A corporate business purpose is necessary for the exchange to be tax-free. It is not clear that qualification as an S corporation will be sufficient.

(2) If the common stock is not too valuable (which may be the case if the freeze was implemented recently), the freeze could be preserved by buying out the common shareholders, converting the preferred stock to common, and transferring the business to a partnership owned by two S corporations: one, the old corporation owned by the older generation, which has a limited preferred interest in the partnership, and the other, a new corporation owned by the younger generation, which has an ordinary interest in the partnership.

b. Preferred stock may be owned by lenders or passive investors

(1) The stock may be redeemed by the corporation for long-term debt

(a) The redemption must be treated as a sale or exchange under I.R.C. § 302 to qualify as an installment sale under I.R.C. § 453.

(b) The debt must not be treated as stock, although debt that is not equity flavored may qualify for a safe harbor that ensures that it will not be treated as a second class of stock. I.R.C. § 1361(c)(5).

(i) The debt must be a written promise to pay a sum certain in money on demand or on a specified date.

(ii) The interest rate and payment dates may not depend on profits, the corporation's discretion, "or similar factors."

(iii) The debt may not be convertible

(iv) The lender must be eligible to be an S corporation shareholder.

c. If preferred stock is § 306 stock a redemption by the corporation or a purchase by other shareholders may result in ordinary income.
d. Differences in voting rights among common shares are permissible. I.R.C. § 1361(c)(4).

e. If the corporation has different classes of common stock, they can be converted into one class with the same rights without tax. A business purpose is not required. I.R.C. § 1036. Regs. § 1.1036-1(a) (provision applies to an exchange between a shareholder and the corporation).

5. The corporation may not have any subsidiaries or otherwise be a member of an affiliated group of corporations within the meaning of I.R.C. § 1504 (determined without regard to the exclusions of subsection (b)). I.R.C. § 1361(b)(2)(A).

a. An affiliated group generally includes corporations linked together by 80% or more common corporate ownership (of both voting power and value).

b. Restructuring to eliminate subsidiaries

(1) Liquidate subsidiary into the corporation

(a) The subsidiary recognizes no gain on the liquidation. I.R.C. § 337(a).

(b) The parent recognizes no gain on the liquidation. I.R.C. § 332.

(c) The subsidiary's tax attributes pass to the parent. I.R.C. § 381.

(2) Shareholders of the corporation can buy enough stock of the subsidiary to reduce the parent's ownership below 80%.

(a) Parent must recognize gain on the sale

(b) When the subsidiary leaves the parent's consolidated return group, income from deferred intercompany transactions may be triggered. Regs. § 1.1502-13(f).

(c) Cost to shareholders can be reduced by having the subsidiary pay a dividend before the sale.

(i) The dividend may reduce the parent's basis in the subsidiary's stock. Regs. § 1.1502-32; I.R.C. § 1059 (subsidiary's stock held for less than 2 years and dividend exceeds 10% of basis).

(ii) A dividend in appreciated property will result in a deferred intercompany gain that is triggered when the subsidiary leaves the consolidated return group. Regs. § 1.1502-13(f).

(3) The subsidiary can sell new stock to existing shareholders or third parties to reduce the parent's ownership below 80%.
(a) This avoids gain recognition to the parent

(b) If the sale is to third parties (e.g., creditors), the stock can be preferred stock that does not dilute the parent's voting control. It may have to be given some limited voting rights or participation in corporate growth to avoid being disregarded entirely under I.R.S. § 1504(a)(4).

(4) Spin-off of subsidiary's stock to parent's shareholders may not qualify for tax-free treatment. I.R.C. will not rule that qualification for subchapter S is a valid business purpose.

c. Care must be taken to ensure that there are no dormant subsidiaries. A subsidiary can be disregarded only if it has never engaged in business and has no gross income during the year. I.R.C. § 1361(c)(6). (A small interest-bearing bank account can be enough to lose the protection of this exemption).

6. Shareholders agreement

a. S corporations, like other closely held businesses, require planning to ensure that control remains within the shareholder group and that an orderly transition occurs when control passes from one generation to the next. A shareholders' buy-sell agreement should be used to help accomplish these objectives.

b. Many problems that must be addressed in a shareholders' agreement for a C corporation must also be addressed in the S corporation context. These include:

   (1) Cross purchase v. stock redemption approach
   (2) Funding of buyout
   (3) Mandatory buyout v. option approach
   (4) Handling of disability

c. A shareholders' agreement for an S corporation must address some special problems.

   (1) An agreement for a C corporation might contain S corporation provisions that take effect automatically when an S election becomes effective.

(a) Preserving the S election

   (i) Types of prohibited shareholders should be mentioned in the agreement. A general reference should also be included in case the law changes.

   (ii) Transfers should be void and not merely voidable. Ltr. Rul. 7716014, revoked by Ltr. Rul. 7748034.
(b) A shareholder who proposes to become an ineligible shareholder should be required to sell his stock to the corporation or other shareholders (e.g., an individual plans to become a nonresident alien).

(c) If a beneficiary of a qualified subchapter S trust proposes to revoke his consent to the S election, the trust should be required to sell its stock.


(2) The agreement might require the shareholders to consent to a § 1377(a)(2) election to close the corporation's books for income allocation purposes when a shareholder is completely bought out.

(3) The agreement might require current distributions to shareholders at a certain level to help them meet their tax liabilities on the corporation's income.

C. Allocating income before year of S election

1. If shareholders are expected to be in lower tax brackets than the corporation during the year before the S election becomes effective, shift income to and deductions from the C corporation period to the S corporation year.

2. Tax elections should be made in a manner that will move income to the year in which the tax impact will be the lowest.

D. Making the S election

1. The corporation must be eligible to make the election for the entire taxable year.
   a. The activities described in II above should occur before the year starts.
   b. If an election is proposed after the year starts, review the corporation's and shareholders' status for the earlier part of the year.

2. The election is made by filing I.R.S. Form 2553 with the Service Center where the corporation will file its U.S. income tax returns.
   a. A failure to file the form defeats the election, even if the intent to elect is shown by other means (e.g., filing a Form 1120S tax return). Pestcoe v. Commissioner, 40 T.C. 195 (1963).
   b. The form must be signed by an officer of the corporation on behalf of the corporation, even if the officer has also signed the form as a shareholder.
c. The form must be filed no later than the 15th day of the third month of the year.

(1) Get proof of receipt from the I.R.S.

(2) The election can be made during the preceding year.


(4) The year begins when the corporation has shareholders, has assets, or starts business. Old Regs. § 1.1372–2(b)(1).

3. The shareholders must consent to the election

a. All persons who are shareholders on the date of the election must consent. I.R.C. § 1362(a)(2). Persons who were shareholders during the year but before the election must consent or the election will not be effective until the next year. I.R.C. § 1362(b)(2)(B)(ii).

b. Persons becoming shareholders after the election need not consent.

c. The consent is normally made on Form 2553, but this is not required. If it is not, the consent should be attached to the Form unless it is filed pursuant to an extension. Temp. Regs. § 18.1362–2(a).

d. The consent is due when the corporation's election is filed. Temp. Regs. § 18.1362–2(a).

(1) This requirement is imposed by the regulations and not by the statute.

(2) The I.R.S. can extend the time in which a shareholder consent may be filed. Temp. Regs. § 18.1362–2(c).

(a) The corporation must demonstrate to the I.R.S. that:

(i) There was reasonable cause for the failure to file the consent on time.

(ii) The government's interests will not be jeopardized by allowing the consent to be filed late.

(b) The shareholder must file a consent within the extension period.

(c) New consents must be filed within the extension period by all persons who have been shareholders at any time during the period starting with the first day of the taxable year and ending on the date on which the extension was granted.

e. Signing the consents. Temp. Regs. § 18.1362–2(b)(2)

(1) If stock is held by joint owners (e.g., tenants in common, community property), both owners must consent. Seely v.
Commissioner, T.C. Memo 1986-216 (failure of spouse in community property state to sign consent invalidated election).

(2) If stock is owned by a minor, consent can be made by:

(a) The minor,

(b) The legal representative (not including a custodian under a gifts to minors act) or

(c) A parent, if there is no legal representative.

(3) If stock is held in trust, each deemed owner or beneficiary (in case of a voting trust) must consent.

4. Separate elections and shareholder consents may be required to qualify the corporation as a pass-through entity for state and local income tax purposes.

E. Subchapter C attributes

1. Earnings and profits

a. The concept of earnings and profits is ordinarily used to determine the extent to which distributions from a corporation are dividends to the shareholder or a return of capital. I.R.C. § 316.

(1) Earnings and profits generally reflect economic income, not taxable income. The phrase is not defined in the Internal Revenue Code, although § 312 describes many of the rules used in calculating it.

(2) Earnings and profits are increased by many items that are not included in gross income (e.g., life insurance proceeds, state and local bond interest).

(3) Earnings and profits are reduced by many items that are not deductible in computing taxable income (e.g., dividends, U.S. income taxes).

b. An S corporation does not have earnings and profits from years during which the S election is in effect, but it may have earnings and profits left over from years during which it was a C corporation.

c. Consequences of an S corporation having subchapter C earnings and profits.

(1) Excess passive investment income ("EPII") is taxed to the corporation at the highest corporate tax rate. I.R.C. § 1375.

(a) EPII is defined as the excess of passive income over 25% of the corporation's gross receipts.
(b) The tax is imposed on net passive income (i.e., gross passive income less deductions directly connected with its production).

(c) Passive income includes rents, royalties, interest (except on sales of inventory and from active finance company operations), dividends, annuities, and gains on sales of stocks and securities.

(2) If an S corporation has EPII for each of 3 consecutive taxable years and has subchapter C earnings and profits at the end of each of those years, the S election terminates for the next year. I.R.C. § 1362(d)(3).

(3) Distributions may be taxed to the shareholders at ordinary income rates to the extent that they exceed the corporation's accumulated adjustments account (generally, the amount of the corporation's retained earnings from subchapter S years). I.R.C. § 1368(c)(2).

d. An S corporation can elect to have a distribution treated as a dividend taxable at ordinary income rates to the extent of subchapter C earnings and profits. I.R.C. § 1368(e)(3). This has the effect of eliminating the subchapter C earnings and profits so that the passive income rules described in I.E.1.c.(1) and (2) no longer apply.

(1) The income resulting from the distribution is in addition to the shareholder's share of the corporation's taxable income for the year.

(2) All shareholders receiving distributions from the corporation during the taxable year must consent to the election.

(a) This includes people who are no longer shareholders at the time of the election.

(b) The I.R.S. has not prescribed procedures for making the election.

e. The tax under § 1375 can be waived by the I.R.S. if the corporation meets certain requirements. I.R.C. § 1375(d).

(1) Requirements

(a) The corporation determined in good faith that it had no subchapter C earnings and profits at the end of the year (or that it had distributed them all). This probably requires showing that a calculation was made.

(b) It distributed the earnings and profits within a reasonable time after a determination of their existence was made.

(i) The determination can be made by the I.R.S. in an audit. Regs. § 1.1375-1A(d)(1).
(ii) The I.R.S. has not indicated what a "reasonable
time" will be.

(2) Procedures for applying for a waiver are prescribed in Regs.
§ 1.1375-1 A(d)(2).

f. The I.R.S. can waive a termination of the S election resulting from
excess passive investment income. I.R.C. § 1362(f).

(1) Requirements

(a) The I.R.S. determines that the termination was inadvertent
(e.g., the corporation thought that it had no subchapter C
earnings and profits).

(b) Steps are taken within a reasonable time to restore
subchapter S status (e.g., a distribution of the newly
discovered earnings and profits).

(c) The corporation and its shareholders agree to make such
adjustments as are required by the I.R.S.

(2) Regulations specifying the waiver procedure have not yet been
adopted.

2. Net operating loss carryovers

a. An S corporation cannot use net operating loss carryovers generated
while it was a C corporation, but the years during which it is an S
corporation count in determining the number of years forward that
those carryovers can be carried under I.R.C. § 172.

b. A C corporation contemplating an S election should try to generate
income in its last year as a C corporation that will use up its net
operating loss carryovers.

c. Techniques to accelerate income into the last C corporation year

(1) Get customers to prepay (e.g., rents)

(2) A cash basis corporation can sell its receivables

(3) Sale and leaseback of corporate property

(4) Defer deductible items

F. Capital Gains


a. A C corporation that elects S status will be taxed on any recognition
during the first 10 years of the election of gain that represents
unrealized appreciation in the value of its assets when the election
became effective.
Purpose: to prevent the use of an S election to avoid the double tax on C corporations and their shareholders resulting from General Utilities repeal.

b. The total amount of gains taxed to the corporation cannot exceed the aggregate net unrealized gain when the election became effective.

(1) Losses are netted against gains. I.R.C. §§ 1374(c)(2) and (d)(1).


c. The gain taxed to the corporation under this provision cannot exceed the corporation's taxable income for the year determined as if it was not an S corporation. I.R.C. § 1374(b)(1)(B). Operating losses and losses from the sale of other assets can reduce the gain that is taxed to the corporation.

d. The corporation is taxed whenever an asset owned on the election's effective date is sold during the next 10 years.

(1) The taxpayer will have the burden of proving that a sold asset was not owned on the election's effective date.

(2) Assets acquired by the corporation in a carryover basis transaction in exchange for an asset owned on the election's effective date will be subject to the tax. Ann. 86-128, I.R.B. 1986-51, 22.

(3) The tax is not limited to sales of businesses or to sales of assets in the conventional sense. It applies to, among other items:

(a) Occasional sales of individual assets

(b) Sales of inventory in the ordinary course of business (although LIFO inventory may, as a practical matter, escape the tax).

(c) The collection of receivables by a cash basis corporation.

e. The taxable gain with respect to each asset will be the excess of the asset's value over its basis on the election's effective date.

(1) The burden of proof will be on the taxpayer. Appraisals should be made when feasible and records should be established at the outset.

(2) It is not clear whether grouping of assets will be permitted.

f. The tax does not apply to the extent that the corporation is eligible for the small corporation exception to General Utilities repeal. T.R.A. 1986 § 632.

(1) The value of the corporation is less than $5,000,000 (a partial exemption is available for corporations worth between $5,000,000 and $10,000,000).
(2) More than 50% of the corporation's stock must have been held by 10 or fewer individuals on August 1, 1986 and for at least 5 years.


2. Corporations electing subchapter S before January 1, 1987, and corporations eligible for the small business transitional rule are subject to the tax on capital gains that was in existence before T.R.A. 1986. Old I.R.C. § 1374.

   a. The tax does not apply if the election was in effect for the 3 taxable years preceding the years in which the gain occurs. The year of the sale is immaterial, so an installment sale can avoid the tax.

   b. The tax applies only if the corporation's net capital gain exceeds both $25,000 and 50% of the corporation's taxable income for the year.

   c. The tax applies only to capital gains. Sales of inventory and ordinary income items are not affected.

   d. The tax is not limited to appreciation as of the election's effective date. It applies to the entire gain.

G. Taxable year

1. Unlike a C corporation, an S corporation is subject to limits on its ability to use a taxable year other than a calendar year.

2. An S corporation must use the calendar year as its taxable year unless it establishes a business purpose for using a different period. I.R.C. § 1378.

   a. A fiscal year C corporation making an S election must change to a calendar year for the first year of the S election. There is no transition period.

   b. If a shareholder as a result has to report items from two years in the same year, the items from the short year can be spread over four years. T.R.A. 1986 § 806(e)(2).

3. Business purpose for a non-calendar year taxable year

   a. A fiscal period may be used as the taxable year if at least 25% of the corporation's gross receipts fall into the last two months of the period for at least three consecutive years. Rev. Proc. 87-32, I.R.B. 1987-28, 14.

   b. The Conference Committee Report for the T.R.A. 1986 indicates that the following factors will not establish a business purpose.

      (1) The use of a particular year for regulatory or financial accounting purposes.

      (2) The time of the year at which hiring occurs.
The use of a particular year for administrative purposes such as admitting or retiring partners or shareholders, staff promotions, and compensation changes.

Changes of prices, model years, and similar items.

II. Conversion to a Partnership

A. Preliminary considerations

1. Unlike conversion to an S corporation, conversion to a partnership involves transferring the business and its assets to a different legal entity.
   a. Title to assets must be transferred
   b. Loan covenants may be triggered and consents of lenders may be required.

2. Consider loss of limited liability
   a. A limited partnership with an S corporation as the general partner may be an answer to the problem. The general partner must have some substance. See Rev. Proc. 72-13, 1972-1 C.B. 735.
   b. Limited liability may be illusory in certain service corporations and may not be that important a factor.

B. Complete conversion to a partnership

1. In a complete conversion, the entire operating business is transferred to a partnership.

2. Liquidation of the corporation
   a. If the corporation does not qualify for the small business exception to General Utilities repeal, the tax consequences can be disastrous.

   (1) Ordinary tax consequences
      a. Corporation pays a tax on any appreciation (34%)
      b. Shareholders pay a tax on their gain on liquidation (28%)
      c. Net U.S. tax liability is 52.5%. This will make liquidation of the C corporation an unacceptable way of converting to a partnership if there is a significant appreciation in value.

   (2) Requirements for small business exception to the corporate level tax. T.R.A. § 633(d).
      a. Liquidation is completed before January 1, 1989
      b. Corporation has a value of less than $5,000,000 (phased out between $5,000,000 and $10,000,000).
(c) On August 1, 1986 and afterwards, more than 50% of the stock (by value) must be held by 10 or fewer individuals (or estate or trusts that could be S corporation shareholders).

The Technical Corrections Act, § 106(g) will add a requirement that they have met this requirement for the five years ending on the date on which the plan of liquidation is adopted.)

(d) The exception does not apply to gain on ordinary income assets

3. Spin-off of business into partnership

a. Technique

(1) Corporation C transfers its business assets to Partnership P in exchange for a limited and preferred interest in P.

(a) C is entitled to a prior claim on annual earnings of P up to a fixed percentage.

(b) C is entitled to a prior claim on P's assets if P is liquidated up to the value of the transferred business. C cannot receive more than this amount.

(2) C's shareholders transfer cash to P in exchange for ordinary interests in P.

(a) They receive all annual earnings of P in excess of C's preferred return.

(b) They receive all liquidation proceeds of P in excess of the amount of C's prior claim.

b. Analysis

(1) The technique is similar to an estate freeze

(a) C's interest is frozen at its value when P is formed

(b) Future growth in the business passes to C's shareholders, who own the unlimited interests in P.

(2) C's income from P can be offset by interest expenses if C borrows money before the transaction and contributes it to P or uses it to buy out some of its shareholders.

c. Tax aspects

(1) If all goes well, the formation of P will be tax-free. The transfer of assets by C to P in exchange for a partnership interest is tax-free under I.R.C. § 721.
(2) Problems

(a) C's interest in P should have a value at least equal to its par value. If it does not, it may be treated as if it paid a dividend to its shareholders equal to the difference. This is the same problem that arises in connection with estate freezes.

(b) I.R.C. § 704(c) requires adjustments to be made if C contributes appreciated property to P.

(i) Any built-in gain must be allocated back to C when the property is sold.

(ii) Depreciation must be allocated among C and the other partners as if the other partners had purchased their shares of the depreciable property from C and then contributed it to P.

4. Techniques for transferring business to a master limited partnership (MLP).

a. C transfers its business to P in exchange for a partnership interest. P then sells interests in P to the public.

b. C transfers its business to P in exchange for many partnership interests. C then sells those interests to the public.

(1) C is taxed on its gain on the sales of MLP interests but not on any units that it keeps. The transfer of its business to P is tax-free under I.R.C. § 721. (Unlike I.R.C. § 351, § 721 does not require C to stay in control of P.)

(2) This involves a conversion of part of C's interest to cash. It is a kind of secondary offering.

C. Partial conversion to a partnership

1. If it is not feasible to transfer the entire business to a partnership, an intermediate technique is to transfer some of the corporation's assets to a partnership so as to insulate future appreciation in their value from the double tax (e.g., real estate).

2. The corporation can contribute the property to a partnership, taking back a limited and preferred interest in the partnership with a par value equal to the property's value. The shareholders can contribute a modest amount of cash to the partnership in exchange for ordinary (i.e., unlimited) partnership interests. See II.B.3. above.

3. Sale-leasebacks

a. Technique: if property is already owned by the corporation, it can be sold to the shareholders and leased back to the corporation, producing many of the advantages described above.
b. Problems to be considered in planning a sale-leaseback.

(1) The price that the shareholder pays to the corporation should be reasonable. If the shareholder pays less than the property's value, the difference will be taxed to him as a dividend.

(2) The shareholders may wish to pay the purchase price over a period of years, particularly if the purchase price is high, as will normally be the case if the property is real estate.

(a) The lease payments can be set at an amount that will cover the installment payments of the purchase price. They must be reasonable in relation to the property's rental value.

(b) The corporation must charge interest at a rate at least equal to 110% of the rate charged on U.S. Treasury obligations of comparable maturity. I.R.C. § 1274(e).

(3) The arrangement must be treated as a sale and lease for tax purposes, not a secured loan. The lease must be treated as a lease and not a sale. Generally, the arrangement should withstand I.R.S. attack if the terms are reasonable and any option in the corporation to repurchase the property is for a fair price. See Frank Lyon Co. v. U.S., 435 U.S. 561 (1978); Faber, "Determining the Owner of an Asset for Tax Purposes," 61 Taxes 795 (1983).

(4) If the sale is to a trust for family members, the trust should be operated in a true fiduciary manner in the best interests of the beneficiaries. Ideally, the trustee should be independent. Similarly, if the sale is to a family partnership, the interests of all partners should be protected.

c. The corporation will be taxed on any gain realized on the sale.

(1) If the shareholder owns 80% or more of the value of the corporation's stock and the property is depreciable, the corporation's gain will be ordinary income.

(2) In any event, the corporation's gain will be ordinary income to the extent required by the depreciation recapture rules. I.R.C. §§ 1245, 1250.

(3) Installment sale treatment may not be available for alternative minimum tax purposes [I.R.C. § 56(a)(6)] and may be limited if the corporation has outstanding debt [I.R.C. § 453C].