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A Comparison of Partnership and S Corporation Exit Transactions

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Mark J. Silverman (cont'd)

Planning and Transactional Practice
Mr. Silverman focuses on planning and transactional matters. He has extensive experience in structuring acquisitions, mergers, and spin-off transactions for large public corporations, as well as closely held businesses. He has authored a book on the tax consequences of financially troubled businesses and advises corporations on consolidated return issues. Mr. Silverman advises leveraged buyout groups, venture capitalists and privately held commercial real estate developers with respect to various transactional matters. He is often called upon to advise the Internal Revenue Service, Treasury Department and the staffs of the Congressional tax writing committees with respect to corporate tax issues.

Tax Policy Practice
A significant part of Mr. Silverman's practice involves the resolution of tax policy issues before Congress and the Treasury Department. These issues arise in the context of pending or proposed legislation and proposed Treasury Department regulations. Mr. Silverman is currently meeting with members of Congress and their staffs on many of the corporate tax provisions proposed by the Administration and by members of Congress (including corporate spin-offs, financial product provisions, and corporate capital gains).

Audit and Controversy
Mr. Silverman also handles audit and controversy matters. He has extensive experience negotiating with field agents, appeals officers and district counsel in settling significant audit issues. Mr. Silverman frequently prepares technical advice requests and often meets with National Office officials with respect to audit and tax litigation matters.

Recently, Mr. Silverman was successful in negotiating global tax shelter settlements with the IRS.
Aaron P. Nocjar is a partner in the Washington office of Steptoe & Johnson LLP, where he is a member of the Tax group. He focuses on federal income taxation issues, with particular emphasis on the taxation of pass-through entities. Mr. Nocjar advises clients in structuring transactions involving partnerships, limited liability companies, S corporations, REITs, and disregarded entities. In addition to providing tax planning advice, Mr. Nocjar assists clients throughout the Internal Revenue Service administrative process. Mr. Nocjar also has experience addressing tax policy issues before Congress and the Treasury Department. Mr. Nocjar's clients range from high-net-worth individuals to family-run, closely-held businesses to multinational groups. The industries he serves include entertainment, hospitality, energy (including alternative energy), the private equity/venture capital/hedge fund space, financial institutions, insurance, government contracts, and real estate development.

PUBLICATIONS
Co-author, Partnership Mixing-Bowl Issues, Practising Law Institute (2011)
Co-author, Partnership Disguised Sale Rules, Practising Law Institute (2011)
Co-author, Section 197 and Partnership Transactions, Practising Law Institute (2011)
Author, Using Tax Partnerships to Trigger Tax Loss in the Commercial Real Estate Market, Tax Management Real Estate Journal (May 2010)
Author, Closely Held Companies: Now Might be the Best Time to Convert to Tax Partnership Status, Journal of Taxation (Oct. 2009)
Author, Section 470 and Partnerships Left Outside Future Congressional Relief, Tax Management Memorandum (2007)
Co-author, Establishing Business Purpose in a Transparent World, 2004 USC Tax Institute
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Georgetown University Law Center
LL.M., Taxation, with distinction, 2001

Case Western Reserve University
J.D., magna cum laude, 1998
Order of the Coif
Executive Articles Editor, Case Western Reserve Journal of International Law

University of Notre Dame
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Purpose of presentation is to compare and contrast exit strategies of owners of partnerships with exit strategies of owners of S corporations.

Presentation organized as follows:
- Similarities between partnerships and S corporations
- Differences between partnerships and S corporations
- Transactional illustrations
Generally, no entity-level tax on earnings
   - Exception for S corporations: built-in gain (BIG) tax and excess net passive income (ENPI) tax

Tax items from entity-level activities flow through to owners annually
   - K-1s issued to owners

Character of entity-level tax items determined at entity level

Owner adjusts its “outside basis” (basis in ownership interest) for its share of entity-level tax items annually

Owners’ ability to deduct entity-level losses subject to passive loss, at-risk, and outside basis limitations

State-law LLC can be partnership or S corporation

Both tax entities can own any percentage interest in C corporations

Both tax entities can own disregarded entities

Both tax entities can be used for small or large businesses
Differences Between Partnerships and S Corporations

- Only S corporations can have a single owner
- S corporations can have only certain types of owners
- S corporations can have up to 100 owners only
- S corporations can have only one class of ownership interest – no common-preferred equity structures
  - However, voting rights can differ
- S corporations can allocate tax items to owners only in “straight up” fashion – no special allocations
- Contributions to S corporations are tax-free only to the extent they meet § 351 requirements
  - Contributions to partnerships are tax-free without § 351 limitations
Differences Between Partnerships and S Corporations

- Third-party debt of S corporation does not increase owners’ outside bases
- Differences between inside and outside bases can be corrected in a partnership
- Distribution by S corporations of appreciated property triggers gain (and for all shareholders) – generally not in partnership distributions
- Most transactional rules for S corporations are Subchapter C rules
  - Transaction rules for partnerships are largely confined to Subchapter K
- Allocable share of income from S corporation not subject to employment tax
  - Distributive share of income from partnership subject to employment tax
- More perceived governmental sympathy for S corporations than partnerships
Tax consequences of exiting business formed as S corporation often differ from tax consequences of exiting business formed as partnership.

Generally cannot convert mid-stream:
- Conversion from partnership to S corporation may not be possible due to type and number of owners and capital structure.
- Conversion from S corporation to partnership generally triggers tax for shareholders.

So, important to consider tax consequences of exiting business at the time of considering what tax entity to use.
Comparative Examples
of Exit Transactions
Partnership:

Redemption Distribution of Cash

- Partner can recognize gain if cash distributed exceeds outside basis
  - Gain is capital gain
  - Except to the extent the partnership held § 751 assets (inventory, unrealized receivables)
- Partner can recognize loss if amount of cash distributed is less than outside basis
- No gain or loss recognized by the partnership
- Note: Amount of cash treated as distributed might be more than meets the eye — § 752
S Corporation:
Redemption Distribution of Cash

- § 302(a) redemption, complete termination of shareholder’s interest under § 302(b)(3)
  - Shareholder can recognize gain to the extent cash distributed exceeds basis in shares
    - Gain is capital gain — no § 751 equivalent that could recast capital gain to ordinary income
  - Shareholder can recognize loss to extent cash distributed less than basis in shares
  - No gain or loss recognized by S corporation
  - Decrease AAA by amount equal to the ratable share of AAA attributable to the redeemed stock as of the redemption date
- Note: Amount of cash treated as distributed is not increased for relief of S corporation debt — no § 752 equivalent
Partner generally does not recognize gain or loss
- Can recognize a gain if cash distributed exceeds outside basis
- Can recognize a loss only if cash, unrealized receivables, or inventory distributed that is less than outside basis
- Holding period of distributed property tacks
- Partner takes a substituted basis in property after outside basis reduced for any cash distributed

- Cannot step up basis on distributed unrealized receivables or inventory — excess outside basis allocated to distributed capital assets or creates loss recognition
- No gain or loss recognized by partnership
- Note: All-property redemption could actually be deemed to include cash if partnership has debt — § 752
S Corporation:
Redemption Distribution of Property

- § 302(a) redemption, complete termination of shareholder's interest under § 302(b)(3)
  - Shareholder can recognize gain to extent net FMV of property exceeds basis in shares
  - Shareholder can recognize loss to the extent net FMV of property is less than basis in shares
- Shareholder takes FMV basis in distributed property (unlike partnership scenario)
- Distribution of appreciated property triggers gain recognition at S corporation level (unlike partnership scenario)
  - Generally, no entity-level tax on such gain (unless BIG tax applies)
  - Recognized gain allocated to shareholders
    - Pro rata v. closing-the-books allocation methods important
- Note: All-property redemption not susceptible to deemed cash distribution - no § 752 equivalent
Partnership:
Redemption Distribution of Marketable Securities

- Distribution of marketable securities treated as distribution of cash
- While generally a redemption distribution of property is tax-free to both the redeemed partner and the partnership, there are exceptions
- Distribution of property – marketable securities – treated as a distribution of cash for purposes of determining gain or loss of the partner
  - Partner takes basis in securities equal to outside basis plus gain recognized
  - Holding period tacks
- No gain or loss recognized by partnership
- Definition of “marketable security” is broad – see § 731(c)
S Corporation:
Redemption Distribution of Marketable Securities

- Same tax consequences as redemption distribution of any other type of property by S corporation
  - Type of property used for redemption is not as important as in partnership scenario
Partnership:
Redemption of Loss Interest

- No gain or loss recognized by any partners, including A
- Built in loss in A’s interest carries over to distributed asset
S Corporation:
Redemption of Loss Stock

- S recognizes no gain because the asset has a FMV basis
- A recognizes $100 capital loss via § 302, but § 267(a) disallows this loss because A is a majority shareholder
- A’s $100 capital loss lost forever? § 267(d) does not appear to apply
- A takes a FMV basis in the capital asset
- Query: what might A do to prevent this outcome? Might A try to sell his interest to B or C instead?
Partnership:
Redemption Distribution of Previously Contributed Property

Year 1: C contributes Property X, FMV $100, basis, $40
Year 5: Partnership distributes Property X to A

While generally a redemption distribution of property is tax-free to both the redeemed partner and the partnership, there are exceptions.

If a partner contributes gain or loss property to the partnership, and within seven years that property is distributed to a different partner, the contributing partner must recognize the built-in gain or loss as if the partnership had sold the property for its FMV at the time of the distribution. § 704(c)(1)(B)

- Partnership recognizes gain (but only up to § 704(c) gain of $60), and gain is allocated to contributing partner C
- Redeemed partner A does not recognize gain (unless deemed distribution of cash causes gain)

- If the distribution is in year 8, there is no § 704(c)(1)(B) trigger
- At time of contribution, important for contributing partner C to limit types of properties that partnership can use for distributions
Same tax consequences as redemption distribution of any other type of property by S corporation

- Type of property used for redemption not as important as in the partnership scenario
- However, note that entity-level gain recognition from distribution of previously contributed property not allocated solely to contributing shareholder C (like in partnership scenario) – rather, allocated to all shareholders
Partnership:
Redemption Distribution of Property to Contributor of Other Property

Year 1

- A contributes Property X, FMV $100, basis, $40
- Year 5: Partnership distributes Property Y to A, FMV of $120, basis $120
- While generally a redemption distribution of property is tax-free to both the redeemed partner and the partnership, there are exceptions.
- Contributing partner must recognize gain if he contributes appreciated property to a partnership and within seven years receives property other than money as a distribution from the partnership. § 737
- Amount of the gain recognized by redeemed partner is the lesser of:
  - FMV of the distributed property, less partner’s outside basis before the distribution (less any cash distributed); or
  - Partner’s net § 704(c) precontribution gain.
- A recognizes $60 gain under § 737
- A’s outside basis increased by $60, and Property X’s inside basis increased by $60 (so, no continuing § 704(c) exposure for continuing partners)
- If the distribution is in year 8, there is no § 737 trigger.
- At time of contribution, important for contributing partner A to limit type and timing of distributions.
**S Corporation:**

Redemption Distribution of Property to Contributor or Other Property

- **Year 1**
  - A, B, C
  - Property X
  - S

- **Year 5**
  - A, B, C
  - Property Y
  - S

- **Same tax consequences as redemption distribution of any other type of property by S corporation**
  - Type of property used for redemption not as important as in the partnership scenario

- **In partnership scenario,** redeemed partner A recognized $60 of § 737 gain (and no gain recognition by partnership and other partners)

- **In S corporation scenario,** no gain recognized at entity level, since Property Y has FMV basis
  - No increase to basis of Property X - continuing shareholders on hook for future gain recognition (unlike partnership scenario)
Partnership:
Redemption Distribution of Property – Inside/Outside Basis Disparity

Liquidating distribution of property to A – Property X has FMV basis
- No gain recognition for any party
- Partner A takes $40 basis in Property X (a $60 “step-down” in basis) – Partner A takes $60 BIG in Property X

Where does this “lost” $60 of basis go?
- If no § 754 election, no adjustment to basis of remaining partnership assets – $60 gain duplicated to detriment of continuing partners B and C
- If § 754 election made, $60 increase to basis of property Y – a “basis shift” of $60 – via § 734(b)

B and C can wait until after A’s liquidating distribution to make the § 754 election for the partnership
No gain/loss recognition at entity-level since distributed property has FMV basis

$60$ gain recognition at shareholder level for $A$ (unlike partnership scenario)

- Property $X$ takes FMV basis ($100$) in $A$'s hands

No ability to adjust basis of remaining assets for such gain recognition - no § 754 equivalent

- $60$ built-in gain remains in Property $Y$ to detriment of continuing shareholders $B$ and $C$
Partnership: Redemption Distribution of Property – Disguised Sale Risks

- Year 5: A contributes $50 cash
- Year 6: Redemption distribution of Property X to A
- Generally, no gain recognized by any party
- Exception for disguised sale of property
  - Non-simultaneous transfers made within two years are presumed to be sales. Treas. Reg. § 1.707-3(c).
- If disguised sale rules apply, partnership treated as selling 50 percent of Property X to A for $50 in year 5, and making redemption distribution of remaining 50 percent of Property X in year 6
  - $30 gain recognition allocated among all partners (but could be specially allocated)
- When planning redemption distribution, need to consider all cash and property transfers in previous two years and expected transfers in subsequent two years
- What if X had been contributed by C in year 5?
S Corporation:
Redemption Distribution of Property - Disguised Sale Risks

Year 5

B

C

A

S

50

Year 6

Property X
FMV $100
Basis $40

A

B

C

S

- Regardless of any application of disguised sale concepts, $60 gain recognized at entity-level, allocated to shareholders
- Is there a role for disguised sale concepts in S corporation context?
  - Substance over form concepts could apply, despite not having to worry about detailed partnership disguised sale rules and their presumptions
- In light of fact that $60 gain recognized at entity-level under § 311, what would disguised sale treatment add?
  - Probably accelerate $30 of $60 gain recognition from Year 6 to Year 5
Partnership:
Redemption Distribution of Property - Hot Asset Issue

- C-M TP
- Inventory, FMV $100, $40 basis
- Cash, $100
- Capital Asset X, FMV $100, $40 basis

Redemption distribution to A of Capital Asset X
Generally, no gain recognized by any party
Exception - Hot Asset Rules - Is there any gain recognized by A, B, or C?
- A gave up its 1/3 interest in "hot assets" (Inv) in exchange for a "cold asset" (additional 1/3 interest in Capital Asset X)
- § 751(b) treats A as receiving a 1/3 distribution of Inv, and then selling such 1/3 interest in A/R for an additional 1/3 interest in Capital Asset X
- A recognizes OI from a deemed sale of 1/3 of Inv - $20 OI
- B and C (but not A) include distributive shares of the capital gain recognized by the partnership on the deemed sale of a 1/3 interest in Capital Asset X -- $20 CG
- Tax basis of Inv and Capital Asset X adjusted accordingly

Could they have avoided this with a liquidating distribution of cash instead?
- Partially - A would still have gain from the deemed sale to the partnership of the 1/3 interest in Inv
- But the partnership (so, B and C) would not have gain from the deemed sale of 1/3 of Capital Asset X to A, since it was deemed to "sell" cash instead
No deemed taxable exchange between A and S corporation of 1/3 interest in Inventory for 1/3 interest in Capital Asset X

- Better than § 751(b) hot asset rules in partnership context, since no OI recognized by redeemed shareholder A
- But, redeemed shareholder A recognizes capital gain to extent FMV of Capital Asset X exceeds A's outside basis (no such gain in partnership context)

However, even worse than § 751(b) hot asset rules in partnership context, $60 (rather than $20) capital gain recognized at entity level, allocated to shareholders

- Distributing cash (rather than Capital Asset X) eliminates all gain for continuing shareholders (and possibly for A)
Partnership:
Redemption Distribution of Note

- Redemption distribution to A with a promissory note of partnership
- A no longer treated as a partner of partnership for state-law purposes, even though he remains a creditor
- A, however, continues to be partner of partnership for tax purposes until note fully paid
  - Receipt of note not treated as distribution of property
  - Continues to receive K-1s
  - Although interests in general profits and losses become zero when receives note, A still can be allocated partnership gain under, for example § 704(c) rules (e.g., partnership sells property previously contributed by A)
- Under default § 736 rules, all outside basis recovered first as note repaid over time, and then § 731 gain recognition thereafter
  - Unclear how interest treated for partnership and A - § 707(c)?
Unlike in partnership scenario, A ceases to be treated as a shareholder upon receipt of note.

- Note treated as property issued in exchange for A’s shares in S:
  - No gain/loss recognized by S
  - Gain/loss recognized by A to extent FMV of note differs from A’s outside basis

- Avoid equity-flavored note to avoid risk of loss of S status (one-class-of-stock requirement)
**S Corporation:**

**Divisive Split-Off**

- S drops assets into a newly formed subsidiary in exchange for stock
- S then distributes Sub stock to C in exchange for his interest in S
- If satisfies § 355 requirements:
  - Tax free under § 355(a) for shareholder C
  - Tax free under § 355(c) for S
- If fails § 355 requirements:
  - Built-in gain in Sub stock recognized by S, allocated to shareholders
  - Shareholder C recognizes additional gain to extent FMV of Sub stock exceeds C's outside basis
- Key: Several requirements to meet for tax-free § 355 treatment
  - Active businesses
  - 5-year active businesses
  - Business purpose
  - Device requirement
  - Must avoid § 355(d) and (e) scenarios
- Can make S election for Sub immediately if get PLR (momentary ineligible shareholder can be disregarded)
Partnership:
Divisive Split-Off

- Drop 1/3 of partnership assets into LLC 1 - disregarded for tax purposes (or, if use C corporation sub, tax-free via § 351)
- Distribute 100% of LLC 1 interests to A - treated as redemption distribution by partnership of assets in LLC 1 (or, if use C corporation sub, redemption distribution of sub stock)
- Generally, tax-free to all parties
- Key: Unlike in S corporation context, no need to meet § 355 requirements
  - No active business requirements
  - No § 355 business purpose needed
A sells B his partnership interest (FMV $100, outside basis $40) for $100 cash
- A has gain of $60
- Note: Could have more gain if being relieved of partnership liabilities as well – § 752
- § 751(a) exception for hot assets: $33 of A's gain is recast as ordinary income
- This is the portion attributable to A's distributive share of ordinary income from the accounts receivable, under the constructive sale under § 751(a) rules
- Remainder of gain ($27) is capital gain
  - Whether it is long term or short term capital gain depends on the partner's holding period in the partnership interest
  - Can split a holding period into long term and short term
- No § 754 election: B is not happy, since A's 1/3 share of gain in A/R (when A/R collected) would be again recognized and now allocated to B
  - A effectively already recognized its 1/3 share of A/R gain when it sold its interest to B
- If § 754 election: Special basis increase of $33 to A/R solely in favor of B via § 743(b), does not benefit C
- If A's sale of interest (coupled with all other sales and exchanges within 12 months) constitutes a sale or exchange of 50 percent or more of total interest in the partnership capital and profits, partnership "technically terminates" via § 708(b)(1)(B)
  - Creates deemed formation of new partnership followed by liquidation of old partnership
  - Causes (i) depreciation restart, (ii) amortization restart if § 754 election made, (iii) closing of taxable year (trap for the unwary if need to make § 754 election for sale transaction between A and B)
  - No need to get new EIN
Unlike partnership scenario, A's stock sale gain should be entirely capital gain — no § 751(a) hot asset equivalent

Unlike partnership scenario, B forced to recognize part of A's 1/3 share of A/R gain when collected — no § 754/§743(b) equivalent

S can elect to close the books
  - If it does not, items of income and loss still will be allocated to A under the per-share, per-day rule
  - Should be part of A's sale negotiations

Unlike partnership scenario, no "technical termination" of S corporation — no § 708(b)(1)(B) equivalent
  - No depreciation/amortization restart
  - No closing of the taxable year
A sells his partnership interest to B in exchange for a note

- A realizes gain on the sale
- But A can defer the recognition of such gain under the installment sale rules of § 453
- A might have to pay the IRS interest on the deferred tax liability, but only if the sales price exceeds $150,000 and all installment notes arising during, and outstanding at end of, such year exceed $5M
- A would lose deferral to the extent disposed of its note prior to satisfaction via § 453B

Query whether income from the sale of a partnership interest that otherwise would be OI under § 751 hot asset rules would be ineligible for deferral under § 453 (e.g., depreciation recapture or unrealized A/R)

Income from the sale of a partnership interest cannot be reported under the installment method to the extent it represents income attributable to any partnership inventories that would not be themselves eligible for the installment method. Rev. Rul. 89-108.

Consider a pre-sale distribution of cash to A

- A could cause partnership to distribute excess cash to extent of outside basis without gain recognition
- A’s interest then could be sold for a lower price, but any gain deferred under installment sale method (unless deferral unavailable due to hot assets)
- Note that each installment would carry a higher percentage of gain recognition
S Corporation:
Installment Sale of Stock to Another Shareholder

- Same tax consequences to selling shareholder as in partnership context
  - However, appears that no risk of loss of deferral due to S corporation OI assets, such as inventory, A/R, or recapture items
  - Also, no ability for continuing shareholders to eliminate inside-outside basis disparities
- Same ability to do pre-sale distribution to selling shareholder
Neither A nor C have enough cash to buy out B directly.

Also, both A and C have very low outside bases—so, any distribution of cash to them (to be used to help acquire B's interest) would trigger gain recognition via § 731.

So, A and C cause partnership to distribute cash in exchange for ½ of B's interest, and A uses own funds to acquire B's remaining interest.

A and C gain more control of partnership with use of partnership funds.

Generally, B should recognize same amount of gain and same character as if B sold entire interest to A or had entire interest redeemed.

- § 754 rules can create difference for continuing partners, however (depends on how much of interest purchased, § 743(b), and how much redeemed, § 734(b)).
- § 751 hot asset rules can create difference for all partners due to how transactions deemed to occur in, and different definitions for hot assets for interest sale vs. interest redemption.
Somewhat similar tax consequences as in partnership scenario

- B sells a portion of his stock in S Corp to A for cash, and causes S Corp to redeem the remainder
  - Need not occur simultaneously, as long as they are part of the same plan
- B is taxed at capital gain rates on cash received in excess of basis
  - No risk of OI recharacterization (unlike partnership context)
- A and C gain more control, but use corporate dollars to partially pay for stock
A sells B his interest in the partnership in exchange for cash. This causes the partnership to terminate under § 708(b)(1)(A).

### Asymmetric tax consequences for A and B

- **A's tax consequences:**
  - Sells his interest in exchange for cash.
  - Recognizes capital gain to the extent the amount realized exceeds his basis.
  - Watch out for hot assets, however, via § 751(a).

- **B's tax consequences:**
  - Step 1: Partnership is deemed to make liquidating distribution of all assets to A and B.
  - Step 2: B is deemed to buy half of the former partnership's assets from A in exchange for cash.

### Overall effects:

- Partnership no longer a partnership for tax purposes — is now a disregarded entity.
- B has split holding period and tax bases in former partnership assets.
- Appears that A and B cannot pick and choose which assets run through A and which are directly distributed to B.
- Unclear whether and how §§ 704(c)(1)(B), 737, and 707(a)(2)(B) apply to deemed liquidating distributions for purposes of B's tax consequences.

What if significant liabilities involved? Are they treated as transferred in same proportions as assets? What if have liabilities between partner and partnership?
Unlike partnership scenario, no deemed transactions for any party

Unlike partnership scenario, S does not terminate (and become a disregarded entity) for tax purposes

A recognizes capital gain to extent cash exceeds outside basis

Also, no hot asset rule equivalent – so no risk of OI recast
Distribute all assets and liabilities in complete liquidation (directly or indirectly via disregarded entity—LLCs)

- Generally, same tax consequences as redemption distributions—could be tax-free to all parties
- However, many potential complications if have hot assets, § 704(c) property (§ 704(c)(1)(B) and § 737), § 754 election (§ 734(b)), or substantial liabilities
More likely that owners will recognize gain on complete liquidation than in partnership scenario

Distribute all assets and liabilities to shareholders in complete liquidation

- Corporate Effects:
  - S recognizes gain as if assets were sold at FMV to shareholders - § 336(a)
  - Gain or loss is taken into account by the shareholders - § 1366
  - Shareholders adjust their outside bases for such gain/loss - § 1367

- Shareholder Effects:
  - Treated as payment in exchange for stock of S - § 331(a)
  - Recognize capital gain or loss to extent FMV of property received (plus cash) less liabilities assumed, exceeds outside basis
  - Shareholders adjust outside bases under § 1367 before applying § 331
  - Shareholders take FMV basis in property received - § 334(a)

- Usually results in only one level of gain recognition (unlike C corporation liquidation)
  - Generally, shareholders recognize entity-level gain via § 336, but do not recognize any shareholder-level gain via § 331
Legacy Owner has operated Business for decades in an S corporation. Legacy Owner wants to wind down participation in Business and pass reins to Next Generation. Legacy Owner wants to preserve value previously built-up in Business, but also wants to grant further upside to Next Generation.

Cannot issue common and preferred interests in S corporation due to second-class-of-stock prohibition. S corporation contributes all or some of the Business to Partnership in exchange for preferred interests in Partnership. Next Generation contributes cash (usually borrowed) to Partnership in exchange for common interests in Partnership.

To avoid Next Generation contributing cash to Partnership, can S corporation contribute Business in exchange for Preferred and Common Interests in Partnership followed by distribution of Common to Next Generation and Preferred to Legacy Owner?