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TAX CONSIDERATIONS IN CHOOSING AND FORMING A (BUSINESS) STRUCTURE OR ENTITY

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TAX CONSIDERATIONS IN CHOOSING AND FORMING A (BUSINESS) STRUCTURE OR ENTITY

I. CHOICE OF ENTITY

Factors affecting the "choice of entity" can (should) include:

A. Owner liability;

B. Owner control and participation in management;

C. Reporting and taxation of income;

D. Changes in ownership – withdrawal, retirement and the like;

E. Allocations of profits and losses;

F. Rights among owners with respect to dispute resolution; and

G. Licensing (e.g., LLCs in California).

1. Under California law, providers of "professional services" generally cannot (legally) form an LLC.

II. TYPES OF STRUCTURES AND ENTITIES

Most businesses are conducted as one of the following, the structure and operation of each of which can generally be varied by law, agreement, and/or "formation documents":

A. Proprietorship. A sole proprietorship involves one owner (and a spouse?) who owns, manages and controls the business. All profits and losses are reported on the proprietor's Form 1040 on Schedule C.

B. Co-Ownership. The simplest structure involving two or more owners, there is usually no significant group activity. Co-owners can enter into co-ownership agreements ("TIC Agreements") to, among other things, create a limited managerial structure that allows for one co-owner or a third party to act on behalf of the others. Profits and losses are generally allocated in proportion to ownership and reported on each respective co-owner's Form 1040.

C. General Partnership ("GP"). A general partnership is a business entity in which two or more co-owners engage in business for profit. All (general) partners are liable for the debts of the partnership. A partnership is not subject to a "partnership"/entity level of tax. Rather, it is a "pass-through"—it reports its income on a Form 1065, and allocates the various components thereof to the partners on K-1s. Distributions to the partners may be "tax free."

D. Limited Partnership ("LP"). A limited partnership is a partnership which has at least one general partner and at least one limited partner. Limited partners are generally not liable for partnership obligations and, unless they have otherwise agreed, they are "at risk" only to the extent of their contributed capital. The general partner(s) is (are) generally liable for all partnership obligations. Like a GP, an LP reports its income on a Form 1065, allocates the various components thereof to its partners on K-1s, and distributions to the partners may be "tax free."

E. Limited Liability Company ("LLC"). A limited liability company is an organization existing under the authority of state law in which all owners generally have limited liability.

1. Single Member. If there is only 1 member of an LLC, the "entity" can be "disregarded" for tax purposes, meaning that the member reports all items of LLC income and expense on the member's Form 1040 (on Schedule C).

2. Multiple Members. If there are multiple members in an LLC, the members can elect to be taxed like a partnership, in which event the LLC will report its income on a Form 1065, and allocate the various components thereof to its members on K-1s. Distributions to the members may be "tax free."

3. Election Out. Alternatively, an LLC can elect to be taxed like a corporation (below).

F. Corporation. A corporation is an organization existing under the authority of state law. It has its own identity, separate and apart from the incorporator, the board of directors, the officers, and/or the shareholders, who generally have limited liability.

1. C Corporation ("C Corp"). A "regular" corporation (a corporation which does not elect to be taxed as an S Corp (below)), can be referred to as a "C Corp". A C Corp reports its income on a Form 1120 and pays tax on that income. Distributions to the shareholders can be taxed (again).

2. S Corporation ("S Corp"). An S Corporation is a corporation which meets certain criteria and elects to be taxed as a pass through. If an effective "S Election" has been made, there is no federal income tax at the corporate level. Rather, the S Corp's income is reported on a Form 1120S, and the various components thereof are allocated to the S Corp's shareholders on a K-1. Distributions to the shareholders may be "tax free."

III. DOUBLE TAXATION

C Corp earnings can be taxed twice. First, on *corporate* income as it is earned. Then, if those earnings are distributed to shareholders (as dividends), each shareholder must pay taxes (again) on his, her or its share of those dividends. (See example on page 28.)

IV. THE CHANGING RELATIONSHIP OF CORPORATE AND INDIVIDUAL FEDERAL INCOME TAX RATES

When a business is owned by individuals, a key factor in comparing the tax consequence of operating as a C Corp versus a flow through (S Corp, LLC or partnership) is the relationship of individual and corporate (federal) income tax rates. This relationship changed with enactment of the American Taxpayer Relief Act of 2012 ("ATRA").

A. The Past. Prior to ATRA, the highest marginal federal income tax rate for corporations and individuals was about the same (35%).

B. The Present. With the enactment of ATRA, the highest tax rates are:

1. For corporations, 35%[1]; and

2. For individuals, 39.6%.[2]

V. CO-OWNERSHIP (Tenancies-in-Common and the Like)

A. Tax Features.

1. Return Reporting. For tax purposes, the principal character of a co-tenancy is that each co-owner is personally responsible to compute his, her or its allocable share of the profits and losses based on his, her or its interest in the activity. Each owner makes all tax elections, separately computes his, her or its depreciation and reports his, her or its allocable share of every revenue and expense item (usually based on the underlying percentage as reflected on title interest).

a. *Example. Individuals A and B co-own property that is leased to others. If A and B are not considered to be in a partnership, A and B may each separately determine the depreciation method they will use to calculate the depreciation expense related to their interest in the property leased.*

[1] Actually, the highest corporate rate is 39% of income from $100,000 to $335,000 (and 38% for income from $15,000,000 to $18,333,333)—see the rate schedule in section IX.B.2.a.ii., below.
[2] Excluding the 3.8% on net investment income.

2. <u>IRC §1031 Tax Exchanges</u>. One "advantage" of co-ownership for real estate is with respect to §1031 tax deferred exchanges, as, upon a sale, each co-owner can independently choose whether to enter into an IRC §1031 tax-deferred exchange.

3. <u>Possible Partnership Treatment</u> With respect to co-tenancies, title is not necessarily conclusive as to tax treatment, meaning that co-owners can be treated (taxed) as partners.

a. <u>Factors Used to Distinguish Partnerships from Co-Tenancy</u>.

i. <u>*Tower & Culbertson*</u>. Two cases (*Comr. v. Tower* (1946) 327 U.S. 280, and *Comr. v. Culbertson* (1949) 337 U.S. 733) follow a "majority of factors" rule to determine if there is a partnership. Factors considered include:

(a) Joint contribution of capital or services;

(b) The purpose of carrying on a trade or business;

(c) Joint ownership of the capital contributions and earning of the enterprise;

(d) Sharing profits and losses;

(e) Mutual control of the business;

(f) The parties' agreement and their conduct relative thereto;

(g) Maintaining separate books of accounts for the business;

(h) Representing the business to others as a partnership; and

(i) Conducting business, holding title to property and filing tax returns in the partnership name.

ii. <u>State Law Factors</u>. Other cases look to the presence of two of three factors (active conduct, business profit motive) as the distinguishing features of a partnership rather than a co-tenancy:

(a) <u>Active Conduct of a Business</u>. There must be an active business for a partnership. If an activity involves passive investment by investors, partnership treatment may not apply and each co-owner could report his or her separate share of income.

(b) Profit Motive. There must generally be a profit motive. An enterprise merely engaged in sharing expenses may not be a partnership. (Treasury Regulations ("Regs.") §§1.761-1(a), 301.7701-3(a).)

(c) Co-Ownership. Mere co-ownership of property does not create a partnership. The Regs. provide that co-owned property that is "maintained, kept in repair, and rented or leased" does not create a partnership. Co-owners who simply provide "customary" services such as heat, water, unattended parking, repairs, trash removal and the cleaning of public areas are not partners. (Regs. §§1.761-1(a), 301.7701-3(a).)

iii. Guidance for What Co-Tenants Can Do: In Revenue Procedure 2002-22, the IRS identified the following "traits" of a co-tenancy:

> Each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. (Rev. Proc. 2002-22, Id.)

Factors Rev. Proc. 2002-22 identified as essential to secure a ruling (that a co-tenancy is not a partnership) include:

- There cannot be previous partnership reporting;
- All co-owners must be entitled to vote;
- Co-owners cannot be restricted as to the right to sell their interest, except as to a first right of refusal to the other co-owners at fair market value;
- Profits and losses must be proportionate in all respects;
- Debt share must be proportionate to sharing of profits and losses;
- Reasonable management agreements are allowed – the management company may maintain an account and must pay out all profits within 90 days;
- A management company is permitted, subject to certain limitations; and
- A co-tenancy agreement ("TIC Agreement") is permitted.

b. Election Out of Partnership Treatment. Given that there is some degree of uncertainty, Internal Revenue Code ("IRC") §761(a) allows for an election out of partnership treatment for certain narrow categories of activities.

i. The most common category is for property (i) held for investment purposes only (not for the active conduct of a business), where (ii) income of the members of the group can be determined without computing partnership taxable income. (IRC §761(a)).

VI. GENERAL PARTNERSHIPS (GPs) AND JOINT VENTURES (JVs)

A. Tax Considerations.

1. Definition. IRC §7701(a)(2) defines a partnership as:

> A syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.

2. Tax Treatment. Partnerships are treated as pass-throughs - the partnership reports to each partner his, her or its allocable (distributive) share of each separate item of partnership income and expense. (This pass-through treatment applies to LPs, LLPs, and LLCs that are taxed as partnerships.)

While many elections are made at a partnership level, certain elections, such as an insolvency determination under IRC §108, must be made at a partner level. Still other elections must be coordinated between the partnership and its partners.

a. Contributions of Appreciated Property. Although partners may generally make capital contributions without recognition of gain (IRC §721), IRC §704(c) requires that allocations of partnership items account for the difference between the fair market value and basis of property contributed to the partnership. This provision prevents shifting built-in gain or loss with respect to contributed property to the other partners. Gain or loss, when recognized by the partnership is first allocated to the contributing partner to account for the difference between fair market value and the contributing partner's basis at the time of the contribution.

Example: *A contributes appreciated land worth $100,000 to the ABC partnership and receives a one-third partnership interest. A's basis in the land is $70,000. If, one year later, the land is sold for $90,000, the $20,000 gain must be allocated entirely to A.*

b. Basis. A partner's basis includes not only cash and the basis of property contributed to the partnership (IRC §722) but is affected by any change in the partner's share of partnership liabilities. (IRC §752(a).) To the extent a partner assumes a greater share of partnership liabilities than previously held, that assumption of liability is treated as a contribution of cash to the partnership which increases that partner's basis in their partnership interest. Conversely, under IRC §752(b), a reduction of a partner's share of partnership debt is treated as a distribution of cash which reduces that partner's basis. (IRC §731(a).) Consequently, while a contribution is normally not taxable, deemed distributions may trigger gain. (IRC §733(1).)

c. Initial Partnership Capital Accounts. Regs. promulgated under IRC §704(b) require not only that there be capital accounts, but that the partnership's accounting be maintained in accordance the Regs., and that allocations have "substantial economic effect."

VII. LIMITED PARTNERSHIPS (LPs)

A. California LP Fees/Taxes. California LPs are subject to an $800 annual minimum tax.

VIII. LIMITED LIABILITY COMPANIES (LLCs)

A. Quick Overview. The main features of an LLC are flexibility and liability protection.

1. Members. An LLC has one or more owners called "members." Somewhat like corporate shareholders, LLC members are generally not personally liable for the business debts of the LLC.

2. Managers or Managing Members. LLC members may choose to operate like a GP, where all members have equal rights to manage the LLC's day-to-day affairs. Alternatively, they may elect one or more "managers" (none of whom need be members) to run day-to-day operations.

3. Permitted Businesses. In California, LLCs are not permitted to engage in any professional business, or any insurance, banking or trust company business.

B. Federal Tax Classification Issues. LLCs have flexibility as to how they are taxed. While less common, they may elect for tax purposes to be treated as a corporation.

1. Default Rules. Under the "default" rules (applicable absent an election to be taxed as a corporation):

a. Multiple Member LLCs. Multiple member LLCs are deemed partnerships for tax purposes. Like partnerships, profits and losses are allocated among the members.

b. Single Member LCCs. For the single member LLC (including husband and wife owners of an LLC), the LLC is treated as a disregarded entity for most tax purposes. (Regs. §301.7701-3(b)(1).)

Example: An LLC passively investing in real estate and owned by a single individual would have its income and deductions reported directly on the owner's individual tax return (on 1040 Schedule E). "Similarly," an LLC owned by a corporation would be treated as a "branch" or "division" of the parent corporation.

C. California Tax and Fees.

1. Minimum Tax. An LLC doing business in California must pay the $800 minimum franchise tax.

2. Additional Fee ("Gross Receipts Tax"). Every California LLC subject to the minimum tax must pay an additional annual fee equal to:

Fee	Total "California" Income
$900	$250,000 - $459,999
$2,500	$500,000 - $999,999
$6,000	$1,000,000 - $4,999,999
$11,790	$5,000,000 or more

The fee is assessed against gross revenues, so it is due notwithstanding profitability.

IX. "HIGHLIGHTS" OF S AND C CORPS

A. Tax Overview.

1. C Corps. As separate taxpaying entities, a corporate income tax is imposed upon the earnings of a C Corp.

2. S Corps. A creature of (federal) tax law, an S Corp is a corporation, all shareholders of which are qualified to be S Corp shareholders, all of whom make an S Election (on Form 2553). An S Corp is a pass-through, taxed similar to a partnership.

To be eligible to make an S Election, a corporation:

a. May have no more than 100 shareholders;

b. May issue only one class of stock (although flexibility is available with regard to differences in voting rights); and

c. Shareholders must be US citizens, resident aliens, certain trusts and other S Corps.

Changes in ownership structure can result in the loss of S Corp status.

<u>Example</u>: *When a resident alien shareholder transfers stock to a nonresident alien, the S Election is terminated.*

B. <u>Tax Considerations</u>.

1. <u>Nonrecognition of Gain or Loss on Incorporation</u>. In organizing a corporation, shareholders usually transfer property to it. If the transfers qualify under IRC §351, <u>no gain or loss</u> is recognized.

a. To qualify for IRC §351 nonrecognition:

i. The transfers must be in <u>exchange</u> for stock or securities;

ii. The shareholders making the transfers must be in <u>control</u>;

iii. The shareholders must not receive anything but <u>stock or securities</u>; <u>and</u>

iv. The shareholders must acquire at least <u>80%</u> of each class of stock. Reg. §1.351-1(a)(1).

b. Nonqualification triggers gain/loss.

c. <u>Liabilities in Excess of Basis</u>. If property transferred to a corporation is subject to liability, that amount equal to the excess of the liabilities over the shareholder's basis in the property is taxable income. (IRC §357.)

2. <u>Taxability of Income</u>.

a. <u>C Corps</u>.

i. <u>Double Taxation</u>. As a C Corp is a separate taxpayer, use of a C Corp can result in double taxation. <u>Three techniques</u> may be used to mitigate double taxation:

- Payment of <u>reasonable compensation</u> to shareholder-employees;
- Payment of <u>other deductible payments</u> to shareholders; and
- <u>Retaining earnings</u>.

(a) <u>Payment of Reasonable Compensation to Shareholder-Employees</u>. Payment of salaries to shareholder-employees will be deductible under IRC §162(a) only if reasonable in amount. If the compensation is unreasonably high, the excess will be treated as a non-deductible dividend under IRC §301.

(b) Other Deductible Payments to Shareholders.

(1) Interest on funds loaned;

(2) Rent on property leased;

(3) Royalties for patents and licenses; and

(4) IRC §83 transfers.

(c) Retention of Earnings. Retaining earnings will defer taxation at the shareholder level until a subsequent transaction, such as payment of deferred compensation or the sale or redemption of shares. Gains subsequently realized and recognized will be capital if the shares are a capital asset in the shareholder's hands and the corporation is not a collapsible corporation under IRC §341.

(1) Two (2) limitations:

i) Accumulated Earnings Tax. Under IRC §531, corporations are subject to a penalty tax on any improper accumulations. Pursuant to IRC §535(c)(2), this tax is imposed on amounts accumulated in excess of $250,000 for most corporations, and $150,000 for certain service corporations. The accumulated earnings tax equals 39.6% of accumulated taxable income. Accumulated taxable income is computed by making certain adjustments to taxable income under IRC §535.

ii) Personal Holding Company Tax. A corporation may also be subject to the personal holding company tax imposed by IRC §541 if 5 or fewer individuals own more than 50% of the value of the corporation's outstanding stock at any time during the last half of the taxable year, and at least 60% of the corporation's adjustable ordinary gross income is personal holding company income as defined in IRC §543(a). (IRC §542.) Under IRC §541, the personal holding company tax equals 39.6% of the corporation's undistributed personal holding company income.

(A) Personal holding company income consists of passive investment income such as dividends, interest, rents and royalties.

ii. Tax Rates (IRC §11(b)). C Corps are taxed at a rate of:

- 15% on taxable income that does not exceed $50,000;
- 25% on taxable income over $50,000 but not exceeding $75,000;
- 34% on taxable income in excess of $75,000, but not exceeding $100,000;
- 39% on taxable income in excess of $100,000, but not exceeding $335,000;

- 34% on taxable income in excess of $335,000, but not exceeding $10,000,000;
- 35% on taxable income in excess of $10,000,000, but not exceeding $15,000,000;
- 38% on taxable income in excess of $15,000,000, but not exceeding $18,333,333; and
- 35% on taxable income in excess of $18,333,333.

(a) Qualified Personal Service Corporations (qualified "PSCs").[3] The graduated corporate tax rates do not apply to qualified PSCs (all income is subject to tax at a 35% rate).

(1) Qualified PSCs are corporations which perform services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, substantially all of the stock of which is held by employee-owners.

b. S Corps. All S Corps are pass-throughs. There is generally no corporate federal income tax, accumulated earnings tax, or personal holding company tax, so long as the S Election is in effect. Exceptions are contained in IRC §1374 (re: built-in gains) and 1375 (re: passive investment income).

i. State Law. California imposes a 1.5% tax on S Corp taxable income and an $800 annual minimum tax.

3. Deductibility of Losses.

a. C Corps.

i. In General.

(a) Corporate Operating Losses. C Corp shareholders are not able to deduct corporate losses against their other sources of income. The C Corp retains use of its losses in the form of net operating loss ("NOL") carryovers.

(1) An NOL carryover may be carried back 2 years and forward 20 years.

(2) NOLs can be lost on a change in ownership.

(b) Losses on Sales of Stock. A shareholder may be able to realize and recognize a loss when they sell their stock, or when their securities become worthless.

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[3] Distinguish PSCs under IRC §§441 and 444.

(1) Pursuant to IRC §1001(a), if a stock sale results in a loss, the shareholder will realize and recognize a capital loss equal to the difference between their adjusted basis in the stock and the selling price.

(2) If a shareholder's securities become worthless, IRC §165(g) provides capital loss recognition on the last day of the taxable year in which such securities become worthless.

(c) <u>Shareholder Loans</u>. Unless the loan generates a business bad debt, deductible as an ordinary loss under IRC §165(a), shareholder loans receive short term capital loss treatment as <u>nonbusiness debts</u> under IRC §166(d)(1)(B).

ii. <u>IRC §1244 Stock</u>. A shareholder may obtain <u>ordinary loss</u> treatment if a corporation issues <u>IRC §1244 small business stock</u>. The sale or worthlessness of common stock which is not IRC §1244 stock results in a capital loss under IRC §165(g).

Under IRC §1244(b), the maximum amount which may be treated as an ordinary loss on IRC §1244 stock in any taxable year is $50,000, ($100,000 for a husband and wife filing a joint return). The benefits of IRC §1244 are limited to the corporation's <u>original investors</u>.

(a) <u>Requirements</u> to qualify under IRC §1244:

(1) The corporation must not have received more than $1,000,000 of money and other property for all of its issued stock (IRC §1244(c)(3)).

(2) The stock must have been issued for money or other property (other than stock or securities) (IRC §1244(c)(1)(B)).

(3) The corporation must have derived over 50% of its aggregate gross receipts for the 5 taxable years prior to worthlessness from sources other than investment activities (IRC §1244(c)(1)(C)).

IRC §1244 stock may be utilized in conjunction with a subchapter S Election.

iii. <u>Qualified Small Business Stock</u>. Individuals and non-corporate investors acquiring newly issued qualified small business stock after August 10, 1993, may qualify for exclusion of 50% to 100% of any gain realized if the stock is held 5 years. (IRC §1202).)

b. <u>S Corps</u>. Subject to passive loss, basis and other limitations, S Corp shareholders may deduct corporate losses against their other income.

i. Basis. An S Corp shareholder's basis is calculated under IRC §1366(d) by aggregating (i) the investment in their stock at the end of the year; and (ii) the amount of any/all loans that shareholder might have made directly to the S Corp.

(a) Planning Point: Because only loans each particular shareholder made to the corporation are included in that shareholder's basis, if losses are foreseen and the corporation needs to borrow funds, shareholders should consider loaning funds to the S Corp, even if they must individually borrow the money lent.

c. At-Risk Rules. The at-risk rules further limit the amount of losses deductible by sole proprietors, partners, S Corp shareholders and certain closely held C Corp shareholders. Under IRC §465, any loss from an activity subject to the at-risk rules is limited to the amount the taxpayer has at-risk with respect to the activity.

i. Amounts At-Risk. Under IRC §465(b), a taxpayer is considered to be at-risk only to the extent of:

(a) The money and adjusted basis of other property contributed to the activity;

(b) Amounts borrowed by the organization if the taxpayer is personally liable for the repayment of the loan.

(1) A taxpayer is personally liable if the loans are recourse or the taxpayer has pledged property (other than property used in the activity) as security for the amount borrowed.

(c) The taxpayer's share of any "nonqualified nonrecourse financing" secured by real property used in the activity. (IRC §465(b)(6).)

ii. Amounts Not At-Risk.

(a) Amounts borrowed from (i) any person having an interest in the activity; (ii) a person related to a person having such an interest; or (iii) a person with an interest beyond that of a creditor.

(b) Amounts protected against loss through nonrecourse financing, stop loss agreements, guarantees and/or similar agreements.

iii. Disallowed Deductions (IRC §465(a)(2)). Any deduction disallowed as a result of the at-risk rules may be allowed in a subsequent year if the taxpayer increases their amount at-risk.

4. Accounting Methods.

a. C Corps.

i. In General. A corporation may adopt any permissible method of accounting. (IRC §446(c).)

ii. IRC §448.

(a) General Rule -- Except as otherwise provided in this section, in the case of a --

(1) C Corp,

(2) partnership which has a C Corp as a partner, or

(3) tax shelter,

taxable income shall not be computed under the cash receipts and disbursements method of accounting . . .

(b) Exceptions:

(1) Farming businesses . . .

(2) Qualified PSCs. . .

(3) Entities with Gross Receipts of Not More Than $5,000,000. – Any corporation or partnership if, for all taxable years beginning after December 31, 1985, such entity (or any predecessor) met the $5,000,000 gross receipts test.

b. S Corps. In general, an S Corp may adopt any permissible method of accounting. (IRC §446(c).)

5. Choice of Fiscal Year.

a. C Corps. The taxpayer's annual accounting period. (IRC §441(a).)

b. S Corps and PSCs.

i. In General. S Corps and PSCs are required to adopt a calendar taxable year unless they have established a business purpose for having a different taxable year.

ii. Business Purpose. Rev. Proc. 87-32 (1987-2 C.B. 14), provides that, to establish a business purpose, S Corps and PSCs[4] must:

[4] Distinguish qualified PSCs under IRC §§11(b) and 448.

(a) Satisfy the "natural business year" test (the 2-month/25% test set forth in Rev. Proc. 83-25);

(b) For S Corps, satisfy an ownership tax year test, in which the S Corp can use the same tax year as that of shareholders owning more than 50% of the S Corp's stock; and

(c) Otherwise establish a business purpose based on all the facts and circumstances, including the tax and nontax consequences.[5]

iii. Revenue Procedure 74-33 (1974-2 C.B. 489). S Corps which have obtained a business purpose exception (not just the 3-month deferral exception) for a taxable year not coinciding with their owners' after Rev. Proc. 74-33 became effective may continue to use their existing taxable years.

iv. PSCs. For purposes of this provision, a PSC is generally defined under IRC §269A(b)(1) as a corporation the principal activity of which is the performance of personal services if services are substantially performed by employee-owners.[6]

v. S Corps -- IRC §444. Under IRC §444(b)(3), an S Corp which had a fiscal year in 1986 may elect to retain such fiscal year after 1986. Alternatively, the S Corp could convert to a taxable year which results in a deferral that is no longer than 3 months or the deferral period for the taxable year which was being changed, whichever is shorter. (IRC §444(b)(2).)

IRC §444(d)(1) provides that the fiscal year election is to be made at the entity level, and is to remain in effect until the entity changes its taxable year. Under IRC §444(d)(2)(A), if an election was not made for the first taxable year beginning after 1986, or the election is terminated, no further election under IRC §444 may be made. In such case, the corporation can convert back to a fiscal year only if it can establish a business purpose for such year. (IRC §1378.)

[5] Rev. Rul. 87-57, 1987-2 C.B. 117, sets forth situations illustrating when a satisfactory business purpose will be deemed to exist. Under the ruling, if the requested tax year creates deferral or distortion of a taxpayer's income, the taxpayer must demonstrate compelling reasons -- more than just issues of convenience -- for the requested tax year.

[6] An employee-owner is any employee of the corporation who owns, on any day during the taxable year, any of the outstanding stock of the corporation. In determining whether an employee owns stock in the corporation, the constructive ownership rules of IRC §318 apply, except that the attribution of stock owned by a corporation to the employee is applied without regard to any requirement that the employee own a certain percentage of the value of the stock of that corporation.

(a) Required (Pre-)Payments. An S Corp which elects to retain a fiscal year under IRC §444 must make the additional payments required by IRC §7519.

vi. PSCs -- IRC §280H. PSCs are also allowed to elect to have a taxable year other than the required taxable year. (IRC §444(a).) Generally, for new entities, the new taxable year may not end more than 3 months prior to the end of the required taxable year. If a taxpayer is changing its taxable year, the deferral period may be no longer than 3 months or the existing amount of deferral in its current taxable year. For a PSC's first taxable year beginning after 1986, IRC §444(b)(3) provides that the corporation may continue to have the same taxable year as its last taxable year beginning in 1986.

(a) (Pro-Rata) Limit on Deductions. Under IRC §280H, if a PSC makes an election under IRC §444, it is subject to the deduction limitations of IRC §280H. IRC §280H(a) limits the deduction of certain amounts paid to employee-owners by PSCs who make the IRC §444 election.

6. Sales of Stock.

a. In General. Corporate shareholders will generally recognize capital gain or loss upon the sale of their stock.

b. Exceptions:

- If the IRC §1222(3) holding period requirement is not met;
- If the shareholder is a dealer in the securities;
- If the corporation is a collapsible corporation; or
- If the sale is structured as a reorganization.

i. Dealers. If the shareholder is a dealer, the shares will generally be considered as property held principally for sale to customers in the ordinary course of business under IRC §1221(1). The sale of shares by a securities dealer will result in the realization and recognition of ordinary income. IRC §1236 provides special rules allowing capital gain treatment for dealers in securities who segregate and clearly identify their portfolios of securities held for investment.

ii. Collapsible Corporations. A collapsible corporation is a corporation that is designed to convert ordinary income to capital gains through liquidation or early sale of stock. IRC §341 defines a collapsible corporation as a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the purchase of IRC §341 assets, with a view to a sale, liquidation, or distribution before:

(1) The corporation has realized 2/3 of the taxable income to be derived from such property; and

(2) The shareholders have realized the gain attributable to the property. A shareholder who disposes of stock in a collapsible corporation will realize and recognize ordinary income.

iii. "Reorganizations." Corporations must qualify under IRC §368 to defer gain.

7. Redemptions.

a. In General. Certain distributions may be treated as redemptions (exchanges).

If the transaction qualifies as a redemption under IRC §302 or §303, the redeemed shareholder (or their estate) will realize and recognize capital gain, but the corporation will not receive any deduction with respect to the redemption transaction. This tax treatment assumes that: (i) the corporation is not a collapsible corporation; (ii) the holding period requirement has been met; and (iii) the shares are a capital asset in the shareholder's hands.

b. IRC §302. Under IRC §302 there are three types of redemptions that qualify for capital gains treatment:

i. A complete termination of the shareholder's interest (IRC §302(b)(3));

ii. A substantially disproportionate distribution with respect to the shareholder (IRC §302(b)(2)); and

iii. A distribution that is not essentially equivalent to a dividend (IRC §302(b)(1)).

Any redemption that does not qualify under one of these 3 tests will be construed as a "regular" corporate distribution, and accorded dividend treatment.

c. Complete Termination. To qualify as a complete termination of a shareholder's interest under IRC §302(b)(3), there must be a termination of the entire stock interest of the shareholder being redeemed.

i. Attribution Rules. The constructive ownership rules of IRC §318 will apply in determining whether the shareholder continues to hold an interest in the corporation. It is possible, however, for a shareholder, under IRC §302(c)(2), to waive the constructive ownership rules dealing with family attribution if the following requirements are met:

(a) The shareholder retains no interest in the corporation other than as a creditor;

(b) The shareholder does not acquire any interest in the corporation for 10 years after the distribution (other than by bequest or inheritance); and

(c) The shareholder files an agreement to notify the IRS of any prohibited acquisition.

d. Substantially Disproportionate Distributions.

i. Requirements. The following requirements must be satisfied (on a shareholder-by-shareholder basis) for a distribution to qualify as substantially disproportionate under IRC §302(b)(2):

(a) Immediately after the redemption, the shareholder must own less than 50% of all the corporation's voting stock (IRC §302(b)(2)(B)); and

(b) The percentage of voting and common stock owned by the shareholder after the redemption must be less than 80% of the percentage of the voting and common stock the shareholder owned before the distribution (IRC §302(b)(2)(C)).

ii. Attribution Rules. Attribution rules generally apply to determine stock ownership before and after the distribution, with the same exception for family attribution provided by IRC §302(c).

iii. Series of Distributions. If the corporation adopts a plan that contemplates a series of distributions which, in the aggregate, will not be substantially disproportionate, then, under IRC §302(b)(2)(D), the plan will not qualify as a substantially disproportionate redemption.

e. Not Essentially Equivalent to a Dividend. Under IRC §302(b)(1), all facts and circumstances will be considered in determining whether a redemption is essentially equivalent to a dividend. A distribution will be essentially equivalent to a dividend unless there has been a meaningful reduction in the shareholder's proportionate interest in the corporation.

i. Planning Consideration. In planning for retirement or death, it is essential that the redemption of the shareholder's stock satisfy one of the above tests for the shareholder to receive capital gain treatment. One way to try to assure this treatment is to enter into a buy-sell agreement under which the corporation (or the remaining shareholders) is required to buy all of the shareholder's shares. While such a sale would appear to qualify as a complete termination, care must be taken to assure that the attribution rules do not cause the shareholder to retain an interest.

f. Redemption to Pay Death Taxes and Funeral and Administrative Expenses (IRC §303). IRC §303 provides that a redemption to pay the shareholder's funeral and administrative expenses, as well as death taxes, will qualify for capital gains treatment even if it might otherwise be taxable as a dividend.

i. Requirements:

(a) The value of the stock must have been included in the shareholder-decedent's gross estate (IRC §303(a));

(b) The amount of the redemption (IRC §303(a)), cannot exceed the amount of estate, inheritance, legacy, and succession taxes (including any interest), and the amount of funeral and administrative expenses allowed as a deduction under IRC §2053.

(c) The shareholder's interest in the corporation is reduced by the amounts paid (IRC §303(b)(3));

(d) The redemption must occur:

(1) After the decedent's death and within 3 years and 90 days after the filing of the estate tax return;

(2) If a petition is filed in Tax Court, within 60 days after the court's decision becomes final; or

(3) If deferred payment of estate taxes is elected under IRC §6166, within the time permitted for the installments (IRC §303(b)(1));

(e) The value of the decedent's stock must exceed 35% of the value of the decedent's adjusted gross estate (IRC §303(b)(2)(A)).

8. Liquidation or Dissolution.

a. C Corps. Distributions of appreciated property by C Corps will be subject to double taxation.

b. S Corps. In contrast, such distributions by S Corps (provided they are not covered by the special rule in IRC §1374 (re built-in gains)) will, in effect, be taxed only once. That follows despite IRC §1363(d) (which requires recognition of gain on such distributions), because the gain is passed through to the shareholders, whose bases are increased by the amount of the gain recognized pursuant to IRC §1367(a)(1).

9. Estate Planning and Income Splitting. An important choice of entity tax consideration involves the individual's estate planning, and the potential for splitting the income among other members of a family who are in a lower tax bracket.

a. C Corp.

i. Transmission of Wealth. Shares of a corporation will pass under a shareholder's testamentary documents (or appropriate intestacy statute) unless the governing instruments of the corporation provide otherwise. Under IRC §1014, the basis of any shares so transferred will be "stepped up" to their date of death/706 estate tax value.

ii. Income Shifting. Transferring shares will shift (dividend) income (the transferees do not have to participate in management to receive distributions). The donor may contribute services to the corporation without receiving compensation. However, the use of a corporation to shift income is limited by:

(a) The sham transaction and business purpose doctrines;

(b) The anticipatory assignment of income doctrine; and

(c) The IRS' power to reallocate income and other items under IRC §482.

b. S Corps. S Corps can be used to shift income if there is a bona fide transfer of stock ownership.

i. A major issue affecting S Corps involves reasonable compensation. If a member of a family of one or more S Corp shareholders renders services for or furnishes capital to the corporation without receiving reasonable compensation, the IRS may make such adjustment . . . as may be necessary in order to reflect the value of such services or capital. (IRC §162(a)(1).)

10. Passive Loss Limitations. Since the passive loss limitations do not apply to widely-held C Corps, these rules should be taken into account in making the choice of entity decision.

11. Charitable Contributions. C Corps cannot claim charitable contribution deductions in amounts in excess of 10% of their taxable income computed with certain modifications. (IRC §170(b)(2).) However, there is a 5-year carryforward of unused deductions subject to this limitation. (IRC §170(d)(2).)

C. S Corps -- Special Issues.

1. Number of Shareholders. The maximum number of shareholders that an S Corp may have is 100.

2. Trusts. Only certain trusts can be S Corp shareholders. Trust permitted to be S Corp shareholders include "grantor trusts," voting trusts, certain testamentary trusts, qualified Subchapter S trusts ("QSSTs"), and "electing small business trusts" ("ESBTs"—trusts in which all beneficiaries are individuals and/or estates, or in which charities may have contingent remainder interests).

a. Holding Periods After Death. A "grantor trust" can remain an S shareholder for up to 2 years after the grantor's death.

3. Invalid S Elections. The IRS has authority to waive invalid S Elections (e.g., because of an inadvertent failure to get all the necessary shareholder consents or to otherwise qualify to elect S status); and treat late elections as timely.

4. Closing Books. If a shareholder terminates his, her or its interest in an S Corp and all affected shareholders consent, the corporation can elect to allocate items of income, deduction, etc., by "closing its books" as of the date of termination.

a. The affected shareholders include only the shareholder whose interest is terminated and any shareholders to whom the terminated shareholder transferred his, her or its shares.

5. Post-Termination Period.

a. Distributions made by a former S Corp during its post-termination period are treated in the same manner as if the distributions were made by an S Corp (e.g., treated as nontaxable distributions to the extent of the accumulated adjustments account). Distributions made after the post-termination period are generally treated as made by a C Corp (i.e., treated as taxable dividends to the extent of earnings and profits).

i. The "post-termination period" includes:

(a) The period beginning on the day after the last day of the last taxable year of the S Corp and ending on the later of: (i) a date that is one year later, or (ii) the due date for filing the return for the last taxable year;

(b) The 120-day period beginning on the date of a determination that the corporation's S Election had terminated for a previous taxable; and

(c) The 120-day period beginning on the date of any determination pursuant to an audit following the termination of the S Election if the audit adjusts any item of income, loss or deduction of the corporation during the period it was an S Corp.

6. Subsidiaries.

a. An S Corp may not have a C Corp shareholder. S Corps can own 80% or more of the stock of C Corps and "qualified subchapter S subsidiaries." To qualify as a "qualified subchapter S subsidiary," the subsidiary would have to:

(a) be 100% owned by the parent S Corp;

(b) be eligible to elect S status if all of its stock were owned directly by its parent S Corp's shareholders; and

(c) have the parent S Corp elect to treat the sub as a qualified subchapter S subsidiary.

7. No Basis Step Up in Inherited S Stock. A person inheriting stock in an S Corp from an individual dying after August 20, 1996, is required to treat as income in respect of a decedent ("IRD") the person's pro rata share of any item of income of the S Corp that would have been IRD if acquired directly from the decedent. The basis of the inherited stock (i.e., the value on the date of death or the alternate valuation date) is reduced by the extent to which its value is attributable to IRD. An income tax deduction is allowed for estate tax attributable to those IRD items.

X. <u>BUILT-IN GAIN AND BUILT-IN LOSS RULES FOR S CORPs, GPs, LPs & LLCs</u>

A. <u>GPs, LPs and LLCs</u>. The inherent ("built-in") gains or losses in property contributed to a partnership are allocated, when recognized, to the contributing partner. (IRC §704(c).)

In contrast, unrealized ("built-in") gain or loss on property transferred to a corporation is shared directly and ratably by all S Corp shareholders and indirectly by C Corp shareholders because the burden or benefit of the corporate tax or saving is allocated ratably to the corporate shares.

B. <u>S Corps</u>. A sale of assets during the "recognition period" by an S Corp that used to be a C Corp is subject to a "built-in-gains" tax. A built-in-gain tax is imposed on the S Corp, at the highest corporate tax rate, on the appreciation in asset value that existed on the date the C Corp became an S Corp. The shareholders may then be subject to a second tax on distribution of the sales proceeds. This built-in gain tax can be eliminated if the S Corp sells appreciated assets originally acquired when it was a C Corp only after the "recognition period" has expired.

Generally, the "recognition period" is 10 years (from 2009 through 2013 it was shortened to 5-7 years). (IRC §1374(d)(7).)

<u>Example 1</u>:

<u>Asset Sale in 2013</u>. ABC, Inc. was incorporated as a C Corp. ABC, Inc. timely filed an election to be treated as an S Corp as of 1/1/08. On the date of conversion, ABC, Inc. had land with a cost basis of $150,000 and a Fair Market Value of $550,000. In April 2013, ABC, Inc. sold the land for $700,000. There is no built-in-gain on the sale of the land because the property was sold after the 5-year recognition period ended on 12/31/12, so ABC, Inc. recognizes a capital gain of $550,000.

<u>Example 2</u>:

<u>Asset Sale in 2014</u>. ABC, Inc. was incorporated as a C Corp. ABC, Inc. timely filed an election to be treated as an S Corp as of 1/1/08. On the date of conversion, ABC, Inc. had land with a cost basis of $150,000 and a Fair Market Value of $550,000. In April 2014, ABC, Inc. sold the land for $700,000. There is a built-in-gain on the sale of the land because the property was sold before the 10-year recognition period ended on 12/31/18.

XI. <u>PAYROLL TAX DIFFERENCES BETWEEN CORPS AND LLCS OR LPS (ASSUMING TRADE OR BUSINESS OPERATIONS)</u>

A. <u>S Corps</u>. Employment taxes often have been the deciding factor in choosing between an S Corp and an LLC. With an S Corp, only the salary paid to the employee-owner is subject to employment taxes but not the undistributed taxable income. (Rev. Rul. 59-221). The salary paid, however, must be reasonable. The IRS has held that when shareholders perform services for an S Corp but don't draw a salary, any "dividends" paid to the shareholders in lieu of reasonable compensation for those services are treated as wages subject to withholding. (Rev. Rul. 74-44.)

B. <u>Partnerships</u>. Generally, partners must pay self-employment taxes on their share of the ordinary income of the partnership, as well as any guarantied payment received. (IRC §1402(a).) A "limited partner" is not required to pay self-employment tax on their share of the ordinary income of the partnership except for guarantied payments received for services. (IRC §1402(a)(13).)

1. <u>Recent Case Law</u>. In 2011, the Tax Court concluded that one's status as a limited partner does not necessarily exempt a partner from self-employment taxes; the exemption depends on the partner's level of participation in partnership business. *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011); *See also Howell v. Commissioner*, T.C. Memo 2012-303.

2. <u>Proposed Regs</u>. Proposed Regs. released in 1997 apply to any entity classified as a partnership for federal tax purposes, regardless of the state-law characterization of the entity as an LP or LLC. Under the proposed Regs., a partner will be treated as a limited partner unless he (1) has personal liability for the partnership's debts; (2) has authority to contract on behalf of the partnership under state law; or (3) participates in the partnership's trade or business for more than 500 hours per year. (Prop. Regs. §1.1402(a)-2(h)(2).) Additionally, an individual who is a service partner in a service partnership may not be a limited partner. (Prop. Regs. §1.1402(a)-2(h)(5).)

a. <u>Exceptions</u>. The proposed Regs. provide 2 exceptions:

i. <u>More than One Class of Interests</u>. The first would apply to holders of more than one class of interest. (Prop. Regs. 1.1402(a)-2(h)(3).) Under this exception, if an individual has rights and obligations with respect to class of partnership interest which rights and obligations are identical to those of limited partners owning a substantial (i.e., at least 20%) and continuing interest in that class, the individual would be treated as a limited partner for that class. In other words, general partners in limited partnerships who also own limited partnership interests may be able to escape self-employment tax on their distributive share of partnership income from the limited partnership interest.

Example:

GP and LP Interests. ABC, LP is a limited partnership with A owning 1% as general partner, and A, B, and C each owning 33% as limited partners. A receives a salary of $50,000 for his services as general partner and at the end of the year ABC, LP has $100,000 in distributive income. A's $50,000 salary and distributive share of $1,000 as general partner would be subject to self-employment tax. However, A's distributive share of $33,000 as an LP would not be subject to self-employment tax since A's LP interest is identical to B and C who have at least 20% LP interest.

ii. More than 500 Hours. The second exception would apply to holders of one class of interest who are not treated as limited partners solely because they participate in the partnership's trade or business for more than 500 hours. (Prop. Regs. §1.1402(a)-2(h)(4).) Under this exception, such an individual is treated as a limited partner if the individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by limited partners owning a substantial (i.e., at least 20%), continuing interest in that class.

Example:

ABC, LP is a limited partnership with A owning 1% as general partner, and A, B, and C each owning 33% as limited partners. B receives a guaranteed payment of $50,000 for 600 hours of services rendered to ABC, LP, and at the end of the year ABC, LP has $100,000 in distributive income. B's income of $50,000 is subject to self-employment tax because it's a guaranteed payment but his distributive share of $33,000 is not subject to self-employment tax his disqualification as a limited partner is solely because he participated in ABC, LP for more than 500 hours and his right and obligations are identical to those of A and C as LPs.

C. C Corps. As a separate taxable entity, the C Corp must withhold payroll taxes from all employees' salaries, including shareholder-employees. The C Corp will then match the amounts withheld (only this "matching" portion of the FICA taxes forwarded to the IRS is deductible by the corporation). Any shareholder who works for the corporation is treated the same as other employees. Since C Corps are separate legal entities, there are no self-employment tax issues for a C Corp.

COMPARISONS

ITEM	PARTNERSHIPS (LLCS)	CORPORATIONS
Taxation (operating profits)[7]	Partnerships are not taxed as separate entities. Partnership income and losses flow "directly" to the partners' (individual) tax returns.	C Corps are taxed as separate legal entities. Shareholders are taxed on dividends paid by the corporation. S Corps are not taxed as separate legal entities. S Corp income and losses flow directly to the shareholders' tax returns.
Losses deductible by owners	Yes, in that amount equal to the sum of the amount invested plus a prorated share of partnership liabilities.	C Corps – no. S Corps – limited to sum of the amount invested and the amount loaned (directly) to the corporation.
Subject to passive activity loss rules (IRC §469)	Yes	C Corps – generally no. S Corps – limited.
Special allocations	Possible, if they have substantial economic effect.	No.
Fiscal Year (IRC §§444, 7579 and 280H)	May end up to 3 months earlier than years of principal partners.	C Corps – any fiscal year. S Corps – may end up to three months earlier than year of principal stockholders.
Tax-free fringe benefits	Limited	C Corps – all permitted by law. S Corps – limited
Tax-free merger (IRC §368)	No, but LLCs can.	C Corps – yes. S Corps – yes.
Accumulated earnings tax (IRC §531)	No.	C Corps – yes. S Corps – no.
Personal holding company tax (IRC §541)	No.	C Corps – yes. S Corps – no.

[7] (See table comparing Federal vs. California Taxes)

FEDERAL vs CALIFORNIA TAX COMPARISONS

	FEDERAL TAX	CALIFORNIA TAX
Partnerships	100% taxed to owner	(a) 100% taxed to owner (b) $800 annual fee for limited partnerships
LLCs	100% taxed to owner	(a) 100% taxed to owner (b) $800 annual fee (c) Gross receipt tax
S Corps	(a) Usually 100% taxed to owner (b) Possible built-in gain tax (c) Possible passive activity loss limitations	(a) Usually 100% taxed to owner (b) Possible built-in gains tax (c) Possible passive activity loss limitations (d) $800 minimum tax (e) 1.5% net income tax
C Corps	100% taxed to corporation	100% taxed to corporation

EXAMPLE 1

DOUBLE TAXATION

		C Corps			**Flow Through* Individual/Owner**
Entity					
Income		$100,000			$100,000
Tax	35.00%	(35,000)			N/A
		$65,000			100,000
Individual Owner					
Income		65,000			100,000
Tax	39.6%	(25,740)		39.6%	(39,600)
NET CASH TO OWNER		$39,260			$ 60,400
Benefit of single Level of Tax:			**21,140**		

* Flow-throughs include S Corps, Partnerships (GPs & LPs) and LLCs

COMPARISON OF LLC GROSS RECEIPTS TAX VS. S CORP TAX

These numbers assume a 20% net profit margin but do not include the $800 annual franchise tax for LLCs.

Net Income	Gross Sales	LLC Gross Receipts Tax	S Corp Tax
$40,000	$200,000	$0	$800*
$70,000	$350,000	$900	$1,050
$140,000	$700,000	$2,500	$2,100
$400,000	$2,000,000	$6,000	$6,000
$1,200,000	$6,000,000	$11,790	$18,000

BASIS AND LOSS LIMITATIONS

<u>"Flow Through" Entity Losses are Limited to the Owner's Basis in the Entity</u>. The allowability of losses for income tax purposes is limited to the owner's basis in the entity.

1. <u>GPs, LPs & LLCs</u>. Under IRC §704(d), partners may deduct partnership operational losses allocated to them to the extent of their adjusted basis in their respective partnership interests. Each partner's basis includes (i) their capital contributions and (ii) their share of partnership debt under IRC §752.

2. <u>S Corps</u>. S Corp shareholders may deduct corporate losses to the extent of their basis in their stock plus any amounts loaned to the corporation by the shareholder. (IRC §1366(d)(1).)

> *<u>Example 1</u>:*
>
> *<u>Shareholder's Basis with Shareholder Debt</u>. In exchange for 100% of stock, A contributed $500,000 to form ABC, Inc., an S Corp. A also loaned $450,000 to ABC, Inc. A's stock basis is $500,000 and his debt basis is $450,000. In Year 1, ABC, Inc. has a loss of $750,000 at the end of the first year. A's stock basis is reduced to $0 and his debt basis is reduced to $200,000.*
>
> *<u>Example 2</u>:*
>
> *<u>Shareholder's Basis with Third-Party Debt</u>. In exchange for 100% of stock, A contributed $500,000 to form ABC, Inc., an S Corp. ABC, Inc. also borrowed $450,000 from a third-party which A guarantied. A's stock basis is $500,000 and his debt basis is $0. In Year 1, ABC, Inc. has a loss of $750,000 at the end of the first year. A's stock basis is reduced to $0. He cannot deduct any portion of the loss in excess of $500,000 because he has no debt basis.*

3. <u>C Corps</u>. As C Corps are not flow throughs, C Corp shareholders may not deduct corporate losses.