PART XIII: CHOICE OF ENTITY AND THE SMALL BUSINESS

8805. What is a sole proprietorship and how is it formed?

A sole proprietorship is an unincorporated business entity that is owned by a single business owner. The primary distinguishing feature of the sole proprietorship is that only one person owns and manages the business. The business exists as an extension of the proprietor.[1]

Because of this, the structure of the sole proprietorship is simple and relatively easy to establish. The proprietor usually need only buy some stock-in-trade, possibly rent some business space, and open his door for business. In some states it will be necessary for the proprietor to file or record what is commonly called a "fictitious business name"; d/b/a or "doing business as"; or "assumed name" registration if the business owner intends to operate the business under a different name than the owner's name. The proprietor may also be required to obtain state and local licenses, if any are applicable to the business.

However, the owner largely avoids the complexity and expense involved in organizing a partnership (see Q 8807), limited liability company (see Q 8843), S corporation (see Q 8835) or C corporation (see Q 8823). A proprietor is not required to draft a partnership agreement, LLC operating agreement or articles of incorporation and bylaws. Therefore, the sole proprietor can avoid the cost of attorney's fees, filing, publication, and recording and annual administrative maintenance costs.

In some cases, however, these advantages are outweighed by the risk of increased liability, an important disadvantage to the proprietorship structure. Since the business is an extension of the proprietor and not a separate legal entity, the liabilities or losses of the business are the personal liabilities and losses of the proprietor. No legal distinction is made between a proprietor's personal liabilities and those created as a proprietor. Therefore, liability for these business obligations is unlimited and unshared. If business assets are insufficient to cover these business liabilities, creditors may reach the proprietor's personal assets to satisfy their claims. A sole proprietorship can also be more difficult to transfer in that the ownership can not be divided.

8806. How is a sole proprietorship taxed?

Legally, a sole proprietorship is not an entity separate from its owner (see Q 8805). As a result, for tax purposes, the proprietor and the enterprise are treated as one indivisible unit. The proprietorship, as such, is not a tax paying entity.

The proprietor reports income and expenses on an individual return (Form 1040). For this purpose, a separate Schedule C is filed, including total proprietorship receipts, inventory, costs, and deductions, to arrive at proprietorship net profit or loss. This net profit or loss from Schedule C is carried to Form 1040, and included in taxable income.[2]

1. See *Williams v. McGowan*, 152 F.2d 570 (1945).
2. See IRS Guidance on Sole Proprietorships, available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Sole-Proprietorships (last accessed June 5, 2014).

In addition to the regular income tax applicable to the proprietorship net income, the Schedule C net income is also subjected to a separate self-employment tax (on Schedule SE), which is intended as a substitute for the Social Security taxes which would have been imposed if the income had been salary or wages paid by an employer (see Q 8547 and Q 8550). Since a sole proprietor is, in effect, both employer and employee, the self-employment tax encompasses both the employer and employee portions of the Social Security taxes on wages.

The estate of a sole proprietor is treated in the same manner as the estate of any other decedent. Unless specific assets pass by trust, contract or survivorship, they will be included in the proprietor's estate and potentially subject to estate taxation. Since the proprietor's business is not a separate entity, the business assets and liabilities also are subject to the estate administration process. This can be of a particular concern if the estate owns some assets which may be risky from a liability perspective.

A "qualified joint venture" that is carried out by a husband and wife may elect to treat their business as two sole proprietorships and not as a partnership for tax purposes. A qualified joint venture is any joint venture conducting a trade or business where the only owners are two spouses, both spouses materially participate in the business, and both spouses elect to opt out of the partnership taxation rules. Items of income, gain, loss, deduction, and credit must be divided between the spouses according to their respective interests in the business.[1] See Q 8810 to Q 8821 for a discussion of the tax treatment of partnerships.

8807. What is a partnership and how is it formed?

A partnership is an arrangement in which two or more parties join together, usually for some profit-motivated activity. Whereas a corporation is recognized as an independently functioning legal entity, separate and apart from its owners (stockholders), the status of a partnership falls somewhere in between that of a separate independent entity and a mere contractual association between participants. It is analagous to a sole proprietorship with multiple owners.

For tax purposes, however, the partnership is not treated as a separately taxable entity (even though it will still have to file a tax return). Instead, the income or loss realized by a partnership is passed through and taxed directly to the parties who are the partners of the partnership at their individual level.[2] This basic approach is the same as the tax treatment of S corporations (see Q 8836 and Q 8837). As is the case with S corporations, the pass-through approach eliminates the double-taxation effect of taxing the same income at the entity level and again when it is distributed to the owners of the entity. Many of the issues which arise in applying this pass-through approach are common to both S corporations and partnerships.

For tax purposes, the term "partnership" may include a general partnership, limited partnership, joint venture, limited liability company, or other unincorporated organization. Beginning in 1997, the IRS replaced the complicated set of rules that existed for use in for determining whether an association or entity was to be treated as a corporation or as a partnership for

1. IRC Sec. 761(f).
2. IRC Sec. 701.

tax purposes with a single taxpayer election approach, known as a "check the box" approach. As a result, non-corporate organizations may file an election to be treated as a corporation or as a partnership for purposes of determining the tax rules to which they will be subject. This is done on IRS Form 8832.

A partnership is formed under an agreement known as the "partnership agreement". The partnership agreement is a written agreement between the partners, covering the organization, conduct, and termination of their common enterprise. This partnership agreement typically also governs the method that will be used for allocating partnership income, loss, deductions and credits among the individual partners. It may also include many provisions associated with a buy-sell agreement (see Q 8852).

8808. How does a partner acquire interests in a partnership? Is the allocation of income amongst partners impacted if a partner acquires a partnership interest by gift?

A person becomes a partner in a partnership through the ownership of a capital interest in a partnership in which capital is a material income-producing factor, whether the interest is acquired by purchase or gift. Generally, such a person will be taxable on his share of partnership profits or losses. If capital is not an income-producing factor in the partnership, the transfer of a partnership interest to a family member may be disregarded as an ineffective assignment of income, rather than an assignment of property from which income is derived.

Generally, the partnership agreement will provide how income and losses will be allocated. However, where an interest is acquired by gift (an interest purchased by one family member from another is considered to have been acquired by gift), the allocation of income, as set forth in the partnership agreement, will not control to the extent that:

(1) it does not allow a reasonable salary for the donor of the interest; or

(2) the income attributable to the capital share of the donee is proportionately greater than the income attributable to the donor's capital share.[1]

The transfer must be complete and the family member donee must have control over the partnership interest consistent with the status of partner. If the donee is not old enough to serve in the capacity of partner, the interest must be controlled by a fiduciary for his benefit.

8809. Is a partnership entitled to deduct its organizational expenses?

A partnership may deduct up to $5,000 of organizational expenses in the year the partnership begins business. The $5,000 amount is reduced (but not below zero) by the amount of organizational expenses that exceed $50,000. If any organizational expenses remain, they may be deducted over a 180-month period beginning with the month that the partnership begins business.[2]

1. IRC Sec. 704(e).
2. IRC Sec. 709(b).

Organizational expenses that may typically be deducted include legal fees for services incident to organization, fees for establishment of the partnership accounting system, and necessary filing fees.[1]

The determination of the date the partnership begins business is a question of fact, but ordinarily it begins when the partnership starts the business operations for which it was organized. For example, the acquisition of operating assets that are necessary to the type of business to be carried on by the partnership may constitute "beginning business." The mere signing of a partnership agreement, however, is not sufficient to show the beginning of business.[2]

8810. How is a partnership taxed?

With the exception of certain publicly traded partnerships, a partnership is not taxed at the entity level.[3] Despite this, the partnership must file an information return on Form 1065 that shows its taxable ordinary income or loss and capital gain or loss. Unlike in the case of a sole proprietorship (see Q 8805), the partnership is regarded as a separate entity for the purpose of computing taxable income, and business expenses of the partnership may be deducted.

In general, a partnership calculates taxable income in the same manner as individuals, except that the standard deduction, personal exemptions, and expenses of a purely personal nature are not allowed.[4] The partnership may also be entitled to a deduction for production activities. Each partner must report his share of partnership profits, whether distributed or not, on his individual return.

In general, after the partnership calculates its taxable income, items of income, gain, loss, deduction or credit are allocated among the partners pursuant to the partnership agreement's provisions, and the partners are taxed on those distributions individually.[5] These tax items are commonly allocated among the partners in direct proportion to their respective percentage ownership interests in the partnership (see Q 8811).

As part of the partnership's income tax return, the partnership is required to issue a Form K-1 to each of the partners. This Form advises each partner how income, loss and other "pass through" items should be reported on the partner's personal income tax return. Therefore, if an individual owns an interest in a partnership (or other "flow through entity", such as an S Corporation or LLC), the individual cannot file their personal income tax return until after the partnership return has been completed.

The situation becomes more complicated, however, when the partnership provides for allocation of income and other cash distributions or losses in a manner which differs from the partners' relative percentage interests in capital. Limited partnerships have long been used as a vehicle for so-called tax-sheltered investments. These ventures are typically structured to

1. Treas. Reg. §1.709-2(a).
2. Treas. Reg. §1.709-2(c).
3. IRC Sec. 701.
4. IRC Secs. 703(a), 63(c)(6)(D).
5. IRC Sec. 704(a).

produce losses and/or tax credits, through liberal use of deductions for depreciation, natural resources depletion or exploration, and other provisions. The partnership agreements spell out the method for allocation of these tax benefits among the various classes of partners.

Thus, depending upon the objectives of the various partners, the tax allocation provisions of the partnership agreement might be drafted in order to allocate tax losses and/or credits to a particular partner or class of partners. Typically, the general partner(s), who are the organizers and managers of a venture will be treated differently from the limited partners, who are the principal providers of capital to the project. Prior to extensive reforms enacted in 1986 (see Q 8627), these types of tax shelter partnerships were widely promoted, with the partnerships' typically substantial tax losses being allocated primarily, if not exclusively, to the passive investors.

Under current law, the allocation specified under the agreement must have a "substantial economic effect." Essentially, this means that the IRS will scrutinize and revise the allocation of tax items among the partners to the extent necessary to be in accordance with each partner's true economic interest in the partnership.[1] See Q 8811 for a detailed discussion of the allocation of income and loss among partners.

Special allocation rules apply where the partner's interest changes during the year.[2]

A partnership which is traded on an established securities market, known as a publicly traded partnership, is taxed differently than a partnership in some instances (see Q 8818 and Q 8819).[3] See Q 8817 for special considerations that may apply in the context of a family partnership.

8811. How is partnership income and loss allocated among partners? What is the "substantial economic effect test"?

The partnership agreement often provides for the allocation of separately stated items of partnership income, gain, loss, deductions and credits among the partners (known as a partner's distributive share), and sometimes provides for an allocation system that is disproportionate to the capital contributions of the partners (a so-called "special allocation"). Despite this, if the method of allocation lacks "substantial economic effect" (or if no allocation is specified), the distributive shares will be determined in accordance with the partner's interest in the partnership, based on all the facts and circumstances.[4]

The substantial economic effect test exists in order to "prevent use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes."[5] Under the regulations, generally, an allocation will not have economic effect unless the partners' capital accounts are maintained properly, liquidation proceeds are required to be distributed based on the partners' capital account balances and, following distribution of such proceeds, partners are required to restore any deficits in their capital accounts to the partnership. Further, the

1. Treas. Reg. §1.704-1(b).
2. IRC Secs. 706(d), 704(b).
3. IRC Sec. 7704.
4. IRC Secs. 704(a), 704(b).
5. Sen. Fin. Comm. Report No. 938, 94th Cong., 2d Sess. 100 (1976).

economic effect will generally not be considered substantial unless the allocation has a reasonable possibility of substantially impacting the dollar amounts received by partners, independent of tax consequences. Allocations are also insubstantial if they merely shift tax consequences within a partnership tax year or are likely to be offset by other allocations in subsequent tax years.[1]

If a partner contributes property to a partnership, allocations must generally be made to that partner to reflect any variation between the basis of the property to the partnership and its fair market value at the time of contribution.[2] When contributed property is distributed to a partner who did not contribute that property, the contributing partner must recognize gain or loss upon distributions occurring within seven years of the contribution.[3] A contributing partner, however, is treated as receiving property which the partner contributed (and no gain or loss will therefore be recognized on the distribution) if the property contributed is distributed to another partner and like-kind property is distributed to the contributing partner within the earlier of (1) 180 days after the distribution to the other partner, or (2) the partner's tax return due date (including extensions) for the year in which the distribution to the other partner occurs.[4]

For contributions of property made after October 22, 2004, if the property has a built-in loss, the loss is considered only in determining the items allocated to the contributing partner. Also, when determining items allocated to other partners, the basis of the property is its fair market value at the time it was contributed to the partnership.[5]

The IRS is entitled to reallocate income and deductions attributable to distributions of property from a partnership to an individual and the individual's controlled corporation to prevent distortions of income.[6] See Q 8812 for special rules that apply to allocations attributable to nonrecourse allocations.

8812. How are partnership losses and deductions attributable to nonrecourse obligations allocated among partners?

Special rules apply to the allocation of losses and deductions attributable to nonrecourse obligations after 1991. If, however, the partnership agreement has not been substantially modified after 1991, transitional rules may permit the use of the earlier regulations under certain circumstances.[7] See below for a discussion of the rules that applied prior to 1992.

For purposes of this discussion, the term "nonrecourse debt" refers to the traditional concept of nonrecourse—where a creditor's right to repayment is limited to one or more assets of the partnership. Nonrecourse liability, on the other hand, means partnership liability with respect to which no partner bears the economic risk of loss. If a partner bears the economic risk of loss

1. Treas. Reg. §1.704-1(b)(2).
2. IRC Sec. 704(c)(1)(A).
3. IRC Sec. 704(c)(1)(B).
4. IRC Sec. 704(c)(2).
5. IRC Sec. 704(c)(1)(C).
6. IRC Sec. 482; *Dolese v. Commissioner*, 811 F.2d 543, 87-1 USTC ¶9175 (10th Cir. 1987).
7. See Treas. Reg. §1.704-2(l).

with respect to nonrecourse debt, deductions and losses allocable to such nonrecourse debt must be allocated to such partner.[1]

Special rules have been developed to govern the treatment of nonrecourse liabilities in the partnership context, because an allocation of a loss or deduction attributable to the nonrecourse liabilities of a partnership ("nonrecourse deductions") cannot have economic effect with respect to a partner. This is because it is the nonrecourse lender, rather than the partner, that bears the risk of economic loss with respect to the deductions.[2] The amount of nonrecourse deductions for a partnership year is equal to the excess, if any, of the net increase in "partnership minimum gain"[3] for the year over the amount of any distributions of proceeds of nonrecourse liabilities allocable to an increase in "partnership minimum gain."

"Partnership minimum gain" is the amount of gain which would be realized in the aggregate if the partnership were to sell each property that is subject to a nonrecourse liability for an amount equal to the nonrecourse liability.[4]

Generally, nonrecourse deductions will be considered to have been allocated in accordance with the partners' interests in the partnership (and the allocation will therefore be honored), if the following requirements are met:

(1) Nonrecourse deductions are allocated in a manner that is consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse financing;

(2) All other material allocations and basis adjustments either have economic effect or are allocated in accordance with the partners' interests in the partnership;

(3) The partners' capital accounts are maintained properly;

(4) Liquidation proceeds are required to be distributed based upon the partners' capital account balances;

(5) Following distribution of liquidation proceeds, partners are required to either (a) restore any deficits in their capital accounts to the partnership or (b) allocate income or gain sufficient to eliminate any deficit;

(6) If there is a net decrease in partnership minimum gain during a year, each partner must be allocated items of partnership income and gain ("minimum gain chargeback") for that year equal to that partner's share of the net decrease in partnership minimum gain. (This requirement does not apply to the extent that a partner's share of the net decrease in minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing it to become partially or wholly recourse

1. Treas. Reg. §1.704-2(i).
2. Treas. Reg. §1.704-2(b)(1).
3. Treas. Reg. §1.704-2(c).
4. Treas. Reg. §1.704-2(d).

debt or partner nonrecourse debt, and the partner bears the risk of economic loss for the liability. Further, it does not apply to the extent that a partner contributes capital to the partnership to repay the nonrecourse liability and the partner's share of net decrease in minimum gain results from the repayment).[1]

Years Beginning After December 29, 1988 and Before December 28, 1991

For those partnerships which qualified under the 1989-1991 rules and which choose to remain grandfathered under such rules, nonrecourse debt is treated under the rules described above.[2] Nonrecourse deductions will be deemed to be allocated in accordance with the partners' interests in the partnership if the requirements (1)-(4) and part (a) of the fifth of the requirements, described above, are met, and if the partnership agreement contains a clause complying with the minimum gain chargeback requirements contained in former Temporary Treasury Regulation Section 1.704-1T(b)(4)(iv). Those requirements provide that if there is a net decrease in partnership minimum gain during a year, each partner must be allocated a minimum gain chargeback equal to the greater of (1) the partner's share of the net decrease in minimum gain attributable to a disposition of property securing nonrecourse liabilities, or (2) the partner's deficit capital account.[3]

Years Beginning Before December 30, 1988

For partnerships which qualified under the rules that applied before December 30, 1988, and choose to remain grandfathered under such rules, nonrecourse debt is treated under the rules described in former Temporary Treasury Regulation Section 1.704-1T(b)(4)(iv),[4] except that:

(1) The amount of nonrecourse deductions for a partnership year is equal to the net increase in partnership minimum gain for the year. There is no reduction for certain distributions as there was under the former temporary regulations;

(2) Nonrecourse deductions need not be allocated in accordance with the partners' interests in the partnership if current requirements (1) through (4) are met and either: (1) following distribution of liquidation proceeds, partners are required to restore any deficits in their capital accounts to the partnership; or (2) if there is a net decrease in partnership minimum gain during a year, each partner must be allocated items of partnership income and gain for that year equal to that partner's share of the net decrease in partnership minimum gain.

8813. How is the tax treatment of a partner's distributive share determined? When does a partner report income and loss?

The character of any item of income, gain, loss, deduction, or credit in the hands of a partner is determined as if such item were realized directly from the source from which it was

1. Treas. Regs. §§1.704-2(b)(1); 1.704-2(e); 1.704-2(f).
2. Former Treas. Reg. §1.704-1T(b)(4)(iv).
3. Former Treas. Reg. §1.704-1T(b)(4)(iv).
4. Former Treas. Reg. §1.704-1(b)(4)(iv).

realized by the partnership, or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain that stems from the sale of depreciable property used in the trade or business of the partnership is treated as though it was gain from the sale of the depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership "hobby losses"[1] or his distributive share of the partnership's charitable contributions retains such character in the hands of the partner.[2]

Where it is necessary to determine the amount or character of a partner's gross income, the partner's gross income includes the partner's distributive share of the gross income of the partnership. This means the amount of partnership gross income from which the partner's distributive share of partnership taxable income or loss was derived (including the various items listed above). For example, a partner is required to include his distributive share of partnership gross income in measuring his gross income for purposes of determining whether a partner is required to file a return.[3]

A partner's distributive share of partnership loss (including capital loss) is deductible only to the extent of the adjusted basis of such partner's interest in the partnership (see Q 8814). Any excess of such loss over such basis may be deducted only if and when the excess is actually repaid to the partnership.[4]

The partner must include the distributive share of partnership items of income, gain, loss, deductions, and credits on his return for the partnership year that ends in or at the same time as the partner's own individual tax year. Since most individuals report on a calendar year basis, an individual partner generally includes partnership income for the same calendar year as a partnership that reports on the calendar year basis. If the partnership uses a non-calendar fiscal year, the calendar year partner includes partnership income, gains, losses, deductions, and credits for the partnership year that *ends* in the partner's calendar year.[5]

8814. How is a partner's basis in the partnership calculated?

A partner's "basis" in the partnership interest is the partner's interest in the partnership for tax purposes. It is used to determine the tax imposed upon cash distributions, gain or loss on sale, and the limit on loss deduction (see Q 8813).

Initially, the partner's basis is the amount of money and the adjusted basis of any property the partner has contributed to the partnership, though it is subject to various adjustments thereafter.[6] The basis is increased by any further contributions and by the partner's distributive share of taxable income, tax-exempt income, and the excess of the deductions for depletion over the basis of the property subject to depletion.[7] The basis is decreased (but not below zero) by current distributions from the partnership, by the partner's distributive share of losses and

1. IRC Sec. 702.
2. Treas. Reg. §1.702-1(b).
3. IRC Sec. 6012(a).
4. IRC Sec. 704(d).
5. IRC Sec. 706(a); Treas. Reg. §1.706-1(a).
6. IRC Secs. 722, 705.
7. IRC Sec. 705(a)(1), Treas. Reg. §1.705-1(a)(2).

nondeductible expenditures not properly chargeable to capital and by the amount of the partner's deduction for depletion with respect to oil and gas wells.[1]

A partner's basis also includes his or her share of partnership liabilities (see Q 8815). Basis is increased by any increase in the share of partnership liabilities, as though the partner had made an additional cash contribution.[2] A partner is deemed to receive a cash distribution to the extent that the partner's share of partnership liabilities decreases. As a result, basis decreases if the share of partnership liabilities decreases.[3]

If a limited partner contributes a personal note to the partnership, the basis in the partnership interest is not increased, however, because it is treated as a contribution of property in which the partner has no basis.[4] When the note is paid, the amount becomes an additional contribution that is added to basis.

Planning Point: A partner's basis is very much of a "moving target" and must be reexamined every time the owner wants to engage in tax planning.

8815. What liabilities are included in determining a partner's adjusted basis in a partnership interest?

A partner's basis includes the partner's share of partnership liabilities.[5] An economic risk of loss analysis is used to determine which liabilities are included in a partner's adjusted basis.

A partnership liability is treated as a recourse liability to the extent that any partner bears the economic risk of loss for that liability.[6] A partner bears the economic risk of loss for a partnership liability to the extent that the partner (or certain related parties) would be obligated to make a payment to any person or make a contribution to the partnership with respect to a partnership liability (and would not be entitled to reimbursement by another partner, certain parties related to another partner, or the partnership) if the partnership were to undergo a "constructive liquidation."

A "constructive liquidation" would treat:

(1) all of the partnership's liabilities as due and payable in full;

(2) all of the partnership assets (including money), except those contributed to secure a partnership liability, as worthless;

(3) all of the partnership assets as disposed of in a fully taxable transaction for no consideration (other than relief from certain liabilities);

1. IRC Secs. 705(a)(2), 705(a)(3).
2. IRC Secs. 752(a), 705(a).
3. IRC Secs. 752(b), 705(a)(2).
4. *Oden v. Comm.*, TC Memo 1981-184; Rev. Rul. 80-235, 1980-2 CB 229.
5. IRC Secs. 752, 705(a).
6. Treas. Reg. §1.752-1(a)(1).

(4) all items of partnership income, gain, loss, and deduction for the year as allocated among the partners; and

(5) the partner's interests in the enterprise as liquidated.[1]

If one or more partners (or related persons) guarantee the payment of more than 25 percent of the interest that will accrue on a partnership nonrecourse liability over its remaining term, the loan will be deemed to be recourse with respect to the guarantor to the extent of the present value of the future interest payments if it is reasonable to expect that the guarantor will be required to pay substantially all of the guaranteed interest if the partnership fails to do so.[2]

An obligation will be considered recourse with respect to a partner to the extent of the value of any property that the partner (or related party in the case of a direct pledge) directly or indirectly pledges as security for the partnership liability.[3] Further, if a partner (or related party) makes a nonrecourse loan, or obtains an interest in such a loan to the partnership and the economic risk of loss is not borne by another partner, the obligation will be considered recourse as to that partner.[4]

A recourse liability allocated to a partner under these rules is included in the partner's basis.

However, a limited partner generally does not bear the economic risk of loss for any partnership recourse liability because limited partners are not typically obligated to make additional contributions and do not typically guarantee interest, pledge property, or make loans to the partnership. Otherwise, a limited partner can include a share of a partnership liability in his basis only if it is nonrecourse liability (see below).

A partnership liability is treated as a *nonrecourse* liability if no partner bears the economic risk of loss (see above) for that liability. Generally, partners share nonrecourse liability in the same proportion as they share profits. However, nonrecourse liabilities are first allocated among partners to reflect each partner's share of (1) any partnership minimum gain or (2) IRC Section 704(c) minimum gain.

Partnership minimum gain is the amount of gain that would be realized if the partnership were to sell all of its property that is subject to nonrecourse liabilities in full satisfaction of such liabilities and for no other consideration. IRC Section 704(c) minimum gain is the amount of gain that would be allocated under IRC Section 704(c) to a partner who contributed property to the partnership if the partnership were to sell all of its property that is subject to nonrecourse liabilities in full satisfaction of such liabilities and for no other consideration.[5]

1. Treas. Reg. §1.752-2(b)(1).
2. Treas. Reg. §1.752-2(e).
3. Treas. Reg. §1.752-2(h).
4. Treas. Reg. §1.752-2(c).
5. Treas. Regs. §§1.752-3(a), 1.704-2(d).

These rules apply to any liability incurred on or after December 28, 1991, except for those incurred or assumed pursuant to a written binding contract that was effective before that date and at all times thereafter. A partnership may elect to apply the provisions of the regulations to liabilities incurred or assumed prior to December 28, 1991, as of the beginning of the first taxable year ending on or after that date.[1]

Similar rules apply to liabilities incurred or assumed by a partnership after January 29, 1989, and before December 28, 1991, unless the liability was incurred or assumed pursuant to a written binding contract that was effective prior to December 29, 1988 and at all times thereafter.[2] They also apply to partner loans and to guarantees of partnership liabilities that were incurred or assumed by a partnership after February 29, 1984, and before December 28, 1991, beginning on the later of March 1, 1984, or the first date on which the partner bore the economic risk of loss with respect to a liability because of his status as a creditor or guarantor of such liability.[3] A partnership could elect to extend application of the temporary regulations to all of its liabilities as of the beginning of its first taxable year ending after December 29, 1988, and before December 28, 1991, subject to certain consistency rules.[4]

8816. How is a sale of partnership interests taxed?

As a practical matter, limited partnership interests are often not freely transferable because there is a lack of a market for the interests. However, in the event that an interest is sold, gain recognized by a limited partner on the sale of an interest is taxed as a long-term capital gain (see Q 8562). Any portion of that gain that is attributable to a limited partner's share of the partnership's IRC Section 751 "unrealized receivables" and "substantially appreciated inventory" items is subject to treatment as ordinary income.

In addition to any requirements in the partnership agreement that must be met upon the transfer of an interest, the IRC requires the transferor-partner to promptly notify the partnership of a transfer of a unit that occurs at a time when the partnership holds unrealized receivables or inventory items that have substantially appreciated in value. A penalty is imposed for a failure to make this notification, unless the failure is due to reasonable cause and not to willful neglect. Once the partnership has been notified, it is required to inform the buyer, the seller and the IRS of the names, addresses and taxpayer identification numbers of the parties to the transfer.

Upon the sale or exchange of, or certain distributions, with respect to a partnership unit, the partnership will be treated as owning its proportionate share of the property owned by any other partnership in which it is a partner. Therefore, if gain is realized upon the sale or exchange of, or certain distributions with respect to, a unit, a portion of the gain may be treated as ordinary income rather than capital gain to the extent it is attributable to unrealized receivables and substantially appreciated inventory held, not only by the partnership, but also by any partnership in which the partnership holds an interest.

1. Treas. Reg. §1.752-5.
2. Temp. Treas. Reg. §1.752-4T(a), prior to removal by TD 8380.
3. Temp. Treas. Reg. §1.752-4T(b), prior to removal by TD 8380.
4. Temp. Treas. Reg. §1.752-4T(c), prior to removal by TD 8380.

If it is found that a limited partner holds an interest primarily for sale to customers in the ordinary course of business, rather than for investment purposes, all gain recognized by that partner upon sale is taxable as ordinary income under the theory that the units are actually inventory held for sale in the ordinary course of business.

The amount of gain recognized by a limited partner on the sale of partnership units is equal to the excess of: (a) the amount realized on the sale of a unit, over (b) the adjusted tax basis of the interest. The amount realized includes cash, the fair market value of other property received on the sale and the partners' share of any qualifying nonrecourse liability of the partnership. Because nonrecourse liabilities must generally be taken into account, it is possible for a partner to be subject to a tax liability that exceeds the actual proceeds received upon the sale of a partnership interest.

The partnership agreement may permit the general partner to make a special election under IRC Section 754 to adjust the basis of partnership property when there is a transfer of a unit or a distribution of partnership assets that takes into account the basis in the partnership unit. If the value of the partnership property has increased, this election would result in the transferee partner having an increased basis in the allocable share of partnership assets and, therefore, the partner would receive more favorable tax treatment (greater cost recovery) if the partnership filed the Section 754 election. A general partner may choose *not* to make this election, however, because of the complexities and added expenses of the tax accounting required. In some cases, this may adversely affect the marketability of partnership interests and the price that a prospective purchaser would be willing to pay for a partnership unit. However, when a partner dies, a Section 754 election allows for a step up in basis for the partner's interest in the partnership's assets. This can be a valuable tax benefit for estates which own interests in partnerships.

Planning Point: In the event a partner in a partnership were to die, the partnership agreement should be examined to determine if a Sec. 754 election is authorized or required. Next, the general partner should be contacted to determine if an election is already in effect. Once an election is in effect under Section 754, it remains in effect for future years and an only be revoked with the consent of the IRS.[1]

8817. What is a family partnership? What special considerations apply in the context of a family partnership?

In the income tax context, a business owner may wish to reduce tax liability by allocating a portion of the business income to minor children, essentially engaging in "income shifting". To this effect, the owner may form a family partnership between the parent and the children in which the children own an interest in the partnership that entitles them to specified portions of the partnership's income.

In theory, if this income was taxable to the children separately, it would be taxed at a lower rate bracket. Today, however, this tax reduction technique has very limited applicability because of the so-called "kiddie tax" (see Q 8557). The kiddie tax requires that "unearned" income of a child under age eighteen, or twenty-four for certain students, be taxed at the parent's tax rate.

1. Treas. Reg. §1.754-1(c).

"Unearned income" is essentially any income other than that received for personal services rendered by the child.

Generally, family partnerships will be recognized for tax purposes only if the following special requirements are met:

(1) A family member, in general, will be deemed to be a partner only if the family member owns a capital interest in partnership property (such as machinery and equipment, real property or inventory) where the business of the partnership is such that capital is a material income-producing factor.[1] If the partnership business is such that personal services are a material income-producing factor, a family member who regularly renders valuable personal service to the business will generally be eligible for partner status for tax purposes. Where a capital interest is required by the underlying nature of the business, the interest may be acquired either by gift or by purchase;[2]

(2) Where the partner receives the partnership interest as a gift, and capital is a material income-producing factor, the donee's distributable partnership share will be included in taxable income except to the extent of:

a. The donor's reasonable compensation for services rendered to the partnership; and

b. A proportionately greater distributive share attributable to donated capital compared to the donor's capital.[3] Thus, although a proportionate share of income attributable to a gifted capital interest may be shifted to a family member, compensation for personal services may not be shifted in such a manner, nor may distributive shares based on capital interests be arbitrarily realigned without proportional reference to the underlying capital interest. This means that where the donor-partner performed all or nearly all of the personal services rendered in connection with partnership activities, income allocated to the donee would be reduced (and taxed to the partner who performed the services) by the reasonable value of the services;

(3) Where an interest in a family partnership is acquired by purchase from another family member, the interest is treated as if it was acquired by gift from the seller unless it can be shown that the sale was a bona fide arm's-length transaction.[4] If the transfer is a gift, the purchaser's (donee's) basis in the interest is limited to the fair market value of the interest and not the purchase price.

For purposes of applying these rules to "family" partnerships, IRC Section 704(e)(3) defines the "family" as including only a spouse, ancestors (including an individual's parents and

1. IRC Sec. 704(e)(1).
2. Treas. Reg. §1.704-1(e)(1)(ii).
3. IRC Sec. 704(e)(2); Treas. Reg. §1.704-1(e)(3).
4. IRC Sec. 704(e)(3), Treas. Reg. §1.704-1(e)(4).

grandparents), lineal descendants (including children and grandchildren); and trusts, if the primary beneficiaries are any of the above.

As a general rule, a family partnership may consist of two or more of the following: a husband, a wife, children, grandchildren, grandparents, or a trust for the benefit of any of those individuals. A partnership formed only by siblings, in-laws, or uncles and aunts is subject only to the rules applicable to partnerships in general, and are not limited by the more restrictive rules imposed on family partnerships.

Although as a general rule, minor children will not be afforded treatment as partners for purposes of Section 704(e), two narrow and limited exceptions do exist for children age 18 and older:

(1) If the minor child can be shown to be competent to manage and own property and to participate in the partnership activities in a manner consistent with the management of such property interests, partnership status may be afforded with the result that the child's distributive share of partnership income will be taxed to the child rather than, for example, to a parent-partner.[1]

(2) Where the exception above cannot be shown to exist, a minor child may still qualify as a partner to the extent partnership income is "earned income."

8818. What is a publicly traded partnership?

A publicly traded partnership is a partnership that is either (1) traded on an established securities market, or (2) is readily tradable on a secondary market or the substantial equivalent thereof (discussed below).[2]

Generally, a partnership that is not traded on an established securities market will be treated as readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market. This occurs if any of the following are true:

(1) partnership interests are regularly quoted by any person making a market in the interests;

(2) any person regularly makes bids or offers quotes pertaining to the interests available to the public and stands ready to effect buy or sell transactions regarding same for itself or on behalf of others;

(3) a partnership interest holder has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or

1. Treas. Reg. §1.704-1(e)(2)(viii).
2. IRC Sec. 7704(b).

(4) prospective buyers and sellers have the opportunity to buy, sell, or exchange partnership interests in a time frame and with the regularity and continuity that is comparable to that described in (1)-(3) above.[1]

Despite this, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof unless (1) the partnership participates in the establishment of the market or the inclusion of its interests thereon, or (2) the partnership recognizes transfers made on that market.[2]

Generally, both general and limited partnership interests are included in calculations of percentage of partnership interests. However, if at any time during the taxable year, the general partner (and certain related persons under IRC Section 267(b) or IRC Section 707(b)(1)) own more than 10 percent of the outstanding interests in partnership capital and profit, the calculations are made without regard to interests owned by the general partner and the related persons.[3]

The percentage of partnership interests that are traded in a tax year is equal to the sum of the monthly percentages. The percentage of partnership interests traded during a month is determined by reference to partnership interests outstanding during the month. Any monthly convention may be used (e.g., first of month, 15th of month, end of month), so long as it is reasonable and used consistently.

In the case of "block transfers," the determination of percentage of partnership interests traded during a thirty day period is made with reference to partnership interests outstanding immediately prior to the block transfer.[4] A block transfer occurs when a partner transfers interests exceeding 2 percent of total interests in partnership capital and profit during a 30 day period.

These rules apply to the taxable years of a partnership beginning after December 31, 1995, unless the partnership was actively engaged in an activity before December 4, 1995. In that case, these rules apply to taxable years beginning after December 31, 2005, unless the partnership added a substantial new line of business[5] after December 4, 1995, in which case these rules apply to taxable years beginning on or after the addition of the new line of business.[6] Different transitional rules applied to certain pre-1996 partnerships.[7]

8819. What special rules apply in the tax treatment of a publicly traded partnership?

A publicly traded partnership will be taxed as a corporation unless 90 percent of the partnership's income is passive-type income and has been passive-type income for all taxable years beginning after 1987 during which the partnership (or any predecessor) was in existence.

1. Treas. Reg. §1.7704-1(c).
2. Treas. Reg. §1.7704-1(d).
3. Treas. Reg. §1.7704-1(k)(1).
4. Treas. Reg. §§1.7704-1(k)(2) to 1.7704-1(k)(4).
5. Treas. Reg. §1.7704-2.
6. Treas. Reg. §1.7704-1(l). Notice 88-75, 1988-2 CB 386, (see below) generally applies to partnerships exempted from the rules in this section.
7. See Notice 88-75, 1988-2 CB 386.

For this purpose, a partnership (or a predecessor) is not treated as being "in existence" until the taxable year in which it is first publicly traded (see Q 8817).[1]

On the first day that a publicly traded partnership is treated as a corporation under these rules, the partnership is treated as though it transferred all assets (subject to its liabilities) to a new corporation in exchange for stock in the corporation, followed by a distribution of the stock to its partners in liquidation of their partnership interests.[2]

In general, "passive-type income" includes interest, dividends, real property rents, gain from the sale of real property, income and gain from certain mineral or natural resource activities, and gain from sale of a capital or IRC Section 1231 asset.[3] ("Passive-type income" for these purposes is different from income derived from a passive activity under the passive activity loss rules, see Q 8637).

The passive-type income exception is not available if the partnership would be treated as a regulated investment company[4] if the partnership were a domestic corporation. The IRS has the authority to provide otherwise if the principal activity of the partnership involves certain commodity transactions.[5]

A partnership that fails to meet the passive-type income requirement may be treated as continuing to meet the requirement if the following are true:

(1) the IRS finds that the failure was inadvertent;

(2) steps are taken so that the partnership once more meets the passive-type income requirement within a reasonable time after the discovery of the failure; and

(3) the partnership and each individual holder agree to make whatever adjustments or pay whatever amounts that the IRS may require with respect to the period in which the partnership inadvertently failed to meet the requirement.[6]

A grandfather rule provided that partnerships that were publicly traded, or for which registrations were filed with certain regulatory agencies, on December 17, 1987 ("existing partnerships"), were exempt from treatment as a corporation until tax years beginning after 1997. Adding a substantial line of business to an existing partnership after December 17, 1987 would terminate the exemption. For purposes of the 90 percent passive-type income requirement above, an existing partnership is not treated as being in existence before the earlier of (1) the first taxable year beginning after 1997 or (2) such a termination of exemption due to the addition of a substantial new line of business. This means that an existing partnership was not

1. IRC Sec. 7704(c)(1); Notice 98-3, 1998-1 CB 333.
2. IRC Sec. 7704(f).
3. IRC Sec. 7704(d)(1).
4. See IRC Sec. 851(a).
5. IRC Sec. 7704(c)(3).
6. IRC Sec. 7704(e).

required to meet the 90 percent requirement while it was exempt under the transitional rules in order to meet the 90 percent requirement when its exemption expired.[1]

A publicly traded partnership taxed as a corporation under the above rules is treated, in general, as a taxable entity and tax benefits are taken at the entity level. Individual investors, therefore, are unable to realize certain tax benefits, such as depreciation deductions and tax credits, on their individual tax returns.

A publicly traded partnership that is taxed as a corporation should not be subject to the "at risk" rules (see Q 8697) or the "passive loss" rules (see Q 8635). Also, a publicly traded partnership would not qualify to make an election to be treated as an S corporation (see Q 8835).

See Q 8820 for safe harbor rules that can allow a partnership to avoid taxation as a publicly traded partnership. See Q 8825 for the tax rules that apply to corporations.

8820. Are there any safe harbor provisions that allow a partnership to avoid taxation as a publicly traded partnership based on a finding that its shares are traded on a secondary market (or the equivalent thereof)?

Several safe harbors exist that allow a partnership to avoid taxation as a publicly traded partnership. Under the "*Private Transfers Safe Harbor*," certain transfers not involving trading (private transfers) are disregarded in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof.[2] These transfers include:

(1) transfers in which the basis of the partnership interest in the hands of the transferee is determined by reference to the transferor's basis or is determined under IRC Section 732;

(2) transfers at death, including transfers from an estate or testamentary trust;

(3) transfers between family members, as defined in IRC Section 267(c)(4);

(4) the issuance of partnership interests for cash, property, or services;

(5) distributions from a qualified retirement plan or individual retirement account;

(6) a partner's transfer of interests exceeding 2 percent of total interests in partnership capital and profit during a 30 day period ("block transfers");

(7) transfers under redemption or repurchase agreements that can only be exercised upon:

   (a) death, disability, or mental incompetence of the partner, or

   (b) the retirement or termination of service of a person actively involved in managing the partnership or in providing full time services to the partnership;

1. TRA '87, Sec. 10211(c), as amended by TAMRA '88, Sec. 2004(f)(2).
2. Treas. Reg. §1.7704-1(e).

(8) transfers of an interest in a closed end partnership pursuant to a redemption agreement if the partnership does not issue any interest after the initial offering (and substantially identical investments are not available through the general partner or certain related parties under IRC Section 267(b) and IRC Section 707(b)(1));

(9) transfers of at least 50 percent of the total interests in partnership capital and profits in one transaction or a series of related transactions; and

(10) transfers not recognized by the partnership.

The "*Redemption and Repurchase Agreements Safe Harbor*" allows transfers involving redemption and repurchase agreements (other than those described in (7) and (8) of "Private Transfers Safe Harbor," above) to be disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof if the following requirements are met:

(1) the agreement provides that the partner must give written notice to the partnership at least 60 days prior to the redemption or repurchase date;

(2) either (a) the agreement provides that the redemption or repurchase price cannot be established until at least 60 days after such notification, or (b) the redemption or repurchase price is not established more than four times during the partnership's taxable year; and

(3) no more than 10 percent of partnership interests are traded during a taxable year (disregarding only private transfers, see above).[1]

The "*Private Placement Safe Harbor*" provides that interests in a partnership will not be treated as publicly traded if: (1) all interests in such partnership were issued in transactions that were not required to be registered under the Securities Act of 1933, and (2) the partnership has 100 partners or fewer at all times during the taxable year. Each person indirectly owning an interest in the partnership through a partnership, S corporation, or grantor trust is treated as a partner if (1) substantially all of the value of the owner's interest in the entity is attributable to its interest in the partnership, and (2) a principal purpose of the tiered arrangement is to satisfy the 100 partner limitation.[2]

A "*Two Percent Safe Harbor*" provides that interests are not tradable on a secondary market or the substantial equivalent thereof if less than 2 percent of the percentage interests in partnership capital or profits are transferred during the taxable year (disregarding certain transfers involving private transfers, those involving qualified matching services, and certain redemption and repurchase agreements).[3]

1. Treas. Reg. §1.7704-1(f).
2. Treas. Reg. §1.7704-1(h).
3. Treas. Reg. §1.7704-1(j).

8821. What is an LLP? How is an LLP taxed?

Many state laws now provide for so-called limited liability partnerships (LLP), a form of partnership which is particularly well-suited for professional partnerships (such as partnerships of attorneys or doctors). To organize as an LLP, the partnership must file a statement of qualification with the relevant state agency.[1]

The LLP form is particularly useful to professional partners because, as the name suggests, it limits the liability of the partners. Traditional partnerships involve unlimited liability of all general partners personally for the obligations and liabilities of the partnership. In a professional partnership of attorneys, for example, this would potentially subject partner A to personal liability for malpractice even though the malpractice is committed by partner B. It is important to understand that while this structure does provide some protection, it does not provide protection from a partner's own malpractice.

If the state in which the partnership operates has an LLP statute, the partnership may choose to register as a LLP in order to eliminate the liability of the general partners for acts or omissions of the other partners, though the general partners will remain liable for their own wrongful acts.[2]

LLPs are taxed in the same manner as a traditional partnership, in that the partners are taxed at the individual level, rather than at the entity level.

Another variation of the LLP is the limited liability limited partnership (LLLP), which provides the typical limited liability to the limited partners, but also limits the liability of the general partners in the same manner (meaning that the assets of those partners are not reachable by creditors of the partnership). However, only certain states authorize creation of the LLLP.[3]

8822. What is a C corporation?

A corporation is a business entity that is treated as an artificial "person" created under state law and granted the right to engage in business by a charter issued by the state.

Planning Point: The corporation will have a "corporate designator" in its name so that people who do business with the entity will know it is a corporation. Some corporate desginators include: incorporated, corporation, company, limited, or an abbreviation thereof. These designators must appear at the end of the corporate name. The idea is to let people who are doing business with an entity know the form of entity with which they are dealing.

As a person, the corporation may sue and be sued, it may buy, sell, and own property in its corporate name, and it may carry on any activities appropriate to the conduct of its business. Thus, property of the corporation along with its debts and liabilities are those of the corporation—not those of the stockholders who own it. As a result, the corporation is also taxed as a separate entity—its tax liabilities are separate and distinct from its stockholder-owners.[4]

1. Revised Uniform Partnership Act ("RUPA"), Secs.101(5), 1001.
2. RUPA, Sec. 306(c).
3. See, for example, Del. Code Ann., Title 6, §17-1105.
4. See IRC Sec. 11.

The corporation's existence is separate from the individuals who own and manage it. It has only the powers expressly or impliedly conferred upon it by the state. A corporation is considered to be a "C" corporation if it is an entity that is incorporated under the laws of one or more states *unless* it has filed an election to be treated as an "S" corporation (see Q 8835). In general, this discussion will refer to C corporations as "corporations" and S corporations as "S corporations." Whether a corporation is a C corporation or an S corporation depends upon a tax election. The non-tax characteristics of these two types of corporations are the same.

Both publicly traded and closely held corporations may be organized as C corporations. A closely held corporation (also referred to as a "close" or "closed" corporation) is one that is owned by one individual or a small number of individuals. The stock of a closely held corporation has a very limited market and will not ordinarily change hands except at the death or retirement of a stockholder or in case of some other major realignment within the company.

The opposite of the closely held corporation is the "publicly held corporation." A publicly held corporation is owned by a substantial number of shareholders, most of whom take no part in the active management of the corporation. Typically, a publicly held corporation is a large corporation whose stock is traded on a stock exchange or on the over-the-counter market.

See Q 8823 for a discussion of the formation of a corporation. Q 8825 discusses the tax treatment of a corporation. See Q 8835 to Q 8842 for a discussion of issues specifically applicable to S corporations.

8823. How is a C corporation formed?

The requirements that apply in forming a corporation vary from state to state. Several states have adopted the Model Business Corporation Act, which can serve to illustrate the basic provisions generally found in individual state statutes.

While a partnership is governed by its partnership agreement, a corporation is governed by its certificate of incorporation (also known as its charter) and bylaws. In the past, for the protection of investors and the general public, business conducted by the corporation was limited strictly to those types of transactions specifically authorized by the corporate charter. Today, most states only require that the purpose of the business, as stated in the charter, be to engage in any lawful business activity. Subject to state law and the terms of the charter, most basic corporate activities are governed by an official set of bylaws.

Planning Point: The by-laws set forth the mechanics as to how the corporation is to function. For example, how directors are elected; how meetings are called and whether business can be conducted without the formality of a meeting. The by-laws can set forth the specific authority of the directors and the officers. Typically, the statutes for the state where the corporation is formed will fill in any gaps which the by laws may not address.

To obtain the authority to conduct business as a corporation, the person organizing the corporation must file certain information with the state of incorporation. Generally, filing requirements include articles of incorporation, a filing fee and written appointment of a statutory agent (for service of process) within the state of incorporation. Most states will provide copies of the

relevant forms on a governmental website. Delaware, which is an extremely common state for corporate formations partially because of its well-developed case law and streamlined formation process, provides links to PDF documents that must be filed based on the type of corporation that will be formed (e.g., stock corporations, public benefit corporations, close corporations, non-profit corporations).[1]

The following elements typically must be included in the articles of incorporation, however, each state may vary this information to some extent:

(1) Name of corporation. The selected corporate name must not be in present use within the state, and must be one which connotes a corporate status (e.g., ABC Company, Inc.; XYZ Corporation). Many states provide a separate process by which a corporation may reserve a corporate name;

(2) Place of business. The complete address of the principal place of business and, often, the address of a registered agent within the state of formation, must be included;

(3) Purpose of business. The essential purpose of the business can be briefly stated (with reliance upon broadly-written state statutes, which generally grant broad operating authority), or a lengthy description of numerous operations may be included. Generally, it seems advisable to add to the present business purpose those closely related operations that might reasonably be entered into at some future date. As a result, should the corporation later broaden its activities, such operations will not constitute *ultra vires* acts of the corporation, nor serve as a basis for dissenting minority stockholder suits. The Delaware forms pre-fill this information with "any lawful act or activity for which corporations may be organized." Other states permit similar approaches;

(4) Number of authorized shares. This means the number of shares that the corporation is permitted to authorize. This does not mean "issued" shares or sold shares, but rather the total number of shares that can be issued at a later date. Often times, the documentation may authorize 1,000 shares and have 100 shares being issued at the inception of the corporation. The 100 issued shares allow the ownership to be held in percentage increments, and there are still 900 shares which can be issued at a later date if necessary. This clause should further state whether the authorized shares carry a par or non-par value;

(5) Minimum stated capital. Some state statutes prescribe a minimum stated capital for the business, usually $500, before the corporation can commence business. Operating before this stated capital is deposited exposes incorporators to personal liability.

1. Delaware filing forms may be accessed at http://corp.delaware.gov/corpformscorp09.shtml (last accessed June 5, 2014).

Optional Provisions

In addition to the essential information that must be included in a filing, in some states, the additional information may be optional, and is most commonly provided in the corporation's bylaws:

(1) Express terms of shares. Where all of the authorized shares are common stock, it is unnecessary to define their terms. However, if there is more than one class of stock, it is important that the following terms be defined (often in the corporation's bylaws): rights to dividends; voting rights; preference on liquidation; preemptive rights to purchase additional stock;

(2) Self-dealing of stockholders. In a closely held business, it is not unusual for stockholders or directors to sell property to or purchase property from the corporation. To preclude dissenting minority stockholder suits, specific authority for such acts should be included in the Articles;

(3) Corporate authority to purchase its own shares. Though many state statues permit the corporation to purchase its own shares, by director action, these permitted purchases are rather narrowly defined. To add flexibility for the stockholders, specific language can be added providing broad authority for such purchases.

8824. Is a corporation entitled to a deduction for the expenses it incurs in organizing as a corporation?

A corporation's expenses of organization (such as filing fees and attorney costs) are not deductible when incurred. However, the corporation may treat these as deferred expenses and deduct them ratably over the 180 month period beginning when the corporation starts business.[1]

8825. How is a C corporation taxed?

Unlike in the partnership context, a corporation is required to file a tax return and pay taxes at the entity level. The owners of the corporation (its shareholders) also pay taxes at the individual level based on any distributions received as dividend income based on stock ownership.

A corporation pays tax according to a graduated rate schedule, which can result in a lower tax rate for corporations with relatively modest earnings. The corporate tax rates range from 15 percent to 35 percent. The first $50,000 of a corporation's earnings is taxed at the 15 percent rate, but the next $25,000 of earnings is taxed at 25 percent. Earnings above $75,000, but below $10,000,000, are subject to a 34 percent rate. A 35 percent rate applies to corporate earnings above the $10,000,000 level.[2]

Taxable income is computed for a corporation in much the same way as for an individual. Generally, a corporation may take the same deductions as an individual, except those of a personal

1. IRC Sec. 248; Reg. §1.248-1.
2. IRC Sec. 11(b).

nature (such as deductions for medical expenses and the personal exemptions). A corporation also does not receive a standard deduction.

Some deductions are allowed specifically for corporations, however, including a deduction equal to 70 percent of dividends received from other domestic corporations, 80 percent of dividends received from a 20 percent owned company, and 100 percent for dividends received from affiliated corporations (see Q 8826 for a detailed discussion of the deductions available with respect to dividends).[1] A corporation may deduct contributions to charitable organizations to the extent of 10 percent of taxable income (with certain adjustments).[2] Generally, charitable contributions in excess of the 10 percent limit may be carried over for five years.[3]

A corporation is also allowed a deduction for production activities. This deduction is equal to nine percent of a taxpayer's qualified production activities income (or, if less, the taxpayer's taxable income). The deduction is limited to 50 percent of the W-2 wages paid by the taxpayer for the year. The definition of "production activities" is broad and includes construction activities, energy production, and the creation of computer software.[4]

Capital gains and losses are netted for a corporation in the same manner as for an individual (see Q 8573) and net short-term capital gain, to the extent it exceeds net long-term capital loss, if any, is taxed at the corporation's regular tax rates.

A corporation reporting a net capital gain (where net long-term capital gain exceeds net short-term capital loss) is taxed under one of two following methods, depending on which produces the lower tax:

1. *Regular method*. Net capital gain is included in gross income and taxed at the corporation's regular tax rates; or

2. *Alternative method*. First, a tax on the corporation's taxable income, exclusive of net capital gain, is calculated at the corporation's regular tax rates. Then a second tax on the net capital gain (or, if less, taxable income) for the year is calculated at the rate of 35 percent. The tax on income exclusive of net capital gain and the tax on net capital gain are added to arrive at the corporation's total tax. For certain gains from timber, the maximum rate is 15 percent.[5]

8826. What is the corporate dividend exclusion?

A corporation, as a legal entity, may own shares in other corporations in the same manner as individuals, and is entitled to receive any dividends on such shares.

However, in computing its taxable income, a corporation, unlike an individual, may deduct 80 percent of dividends received from domestic corporations if it owns at least 20 percent but less

1. IRC Sec. 243.
2. IRC Sec. 170(b)(2).
3. IRC Sec. 170(d)(2).
4. IRC Sec. 199.
5. IRC Secs. 1201, 1222.

than 80 percent of the stock.[1] For corporations that own less than 20 percent of the distributing corporation the deduction is limited to 70 percent of the dividends received.[2] Dividends received are 100 percent deductible if the recipient is a small business investment company operating under the Small Business Investment Act, or, subject to certain conditions, if the recipient is a member of the same affiliated group of corporations as the issuer of the dividends (generally meaning 80 percent or more common ownership).[3]

In order to prevent abuse of the dividends-received deduction through extremely short-term investments designed only to capture imminent dividends on a tax-free basis, the deduction is available only if the stock is held for a minimum period, depending on the type of stock involved.

Dividends from Foreign Corporations

Dividends received by a domestic corporation which owns at least 10 percent of a foreign corporation are subject to a domestic corporation deduction only to the extent that the dividends are deemed attributable to U.S. source income of the foreign corporation. This is computed by applying to the dividends received a ratio equal to the ratio of U.S. source income to total income of the foreign corporation. Once the U.S.-source portion is determined, the deduction is then limited, depending on the percentage ownership of the foreign corporation. If the domestic corporation owns at least 10 percent, but less than 20 percent, the deduction is 70 percent of the U.S.-source portion of the dividends received. If the percentage ownership is at least 20 percent, the portion deductible increases to 80 percent of the U.S.-source dividends received.

A 100 percent deduction is allowed for dividends received from a foreign wholly-owned subsidiary of a domestic corporation, provided that all of the subsidiary's income is effectively connected with a U.S. trade or business. Special rules apply in the case of dividends received from certain foreign sales corporations (FSCs).[4]

Debt-Financed Portfolio Stock

The dividends-received deduction is further limited with respect to dividends received from debt-financed portfolio stock. In general, the otherwise allowable deduction (after applying the other limitations) must be reduced by a percentage equal to the percentage of the cost of the dividend-yielding stock which was debt-financed.[5]

8827. How is a C corporation shareholder taxed upon the sale of the shareholder's stock in the corporation?

Generally, a shareholder who sells or exchanges stock for other property realizes a capital gain or loss.[6] Whether such gain or loss is short-term or long-term usually depends on how long

1. IRC Sec. 243(c).
2. IRC Sec. 243(a)(1).
3. IRC Sec. 243(a)(3).
4. IRC Secs. 245 and 922.
5. IRC Sec. 246(a).
6. See IRC Secs. 1221, 1222.

the shareholder held the stock before selling (or exchanging) the stock.[1] For an explanation of how the holding period is calculated, see Q 8568; for the treatment of capital gains and losses, including the current tax rates applicable for capital gains, see Q 8561 to Q 8576.

When shares of stock are sold, the amount of gain (or loss) is the difference between the selling price and the shareholder's tax basis in the shares at the time of sale. If the shares are exchanged for property, or for property and cash, the amount of gain (or loss) is the difference between the fair market value of the property plus the cash received in the exchange and the shareholder's tax basis.[2]

Despite this, if common stock in a corporation is exchanged for common stock in the same corporation, or if preferred stock is exchanged for preferred stock in the same corporation, gain or loss is generally not recognized unless cash or other property is also received. In this case, the exchange is taxed in substantially the same manner as a "like-kind" exchange.

The exchange of shares of different corporations and exchanges of common for preferred do *not* qualify for the general "like-kind" exchange rules, even if the shares are similar in all respects.[3] The nonrecognition rules of IRC Section 1036 apply to exchanges of common stock for common stock in the same corporation, even though the shares are of a different class and have different voting, preemptive, or dividend rights.[4]

For an explanation of "like-kind" exchanges, see Q 8606. See Q 8828 for considerations that apply in determining a stockholder's basis in corporate stock.

8828. What special considerations apply in determining a stockholder's basis in securities, such as corporate stock?

If an individual's holdings in a particular security were all acquired on the same day and at the same price, there is little difficulty in establishing the tax basis and holding period of the securities subject to the sale or exchange. When an individual sells or otherwise transfers securities from holdings that were purchased or acquired on different dates or at different prices (or at different tax bases), the process becomes more difficult. See Q 8565 for a discussion of the general rules applicable in determining a taxpayer's basis in an asset.

In the context of corporate securities, the individual must generally be able to identify the lot from which the transferred security originated in order to determine tax basis and holding period. Unless the individual can "adequately identify" the lot from which the securities being sold originated, the securities sold will be deemed to have come from the earliest of such lots purchased or acquired, by a "first-in, first-out" (FIFO) method.[5] However, in cases involving mutual fund shares, the selling shareholder may be permitted to use an "average basis" method to determine tax basis and holding period in the securities transferred.

1. See IRC Secs. 1222, 1223.
2. See IRC Sec. 1001.
3. IRC Sec. 1036; Treas. Reg. §1.1036-1. See IRC Sec. 1031(a).
4. Rev. Rul. 72-199, 1972-1 CB 228. See Treas. Reg. §1.1036-1.
5. Treas. Reg. §1.1012-1(c)(1).

Generally, identification is determined by the certificate delivered to the buyer or other transferee. The security represented by the certificate is deemed to be the security sold or transferred. This is true even if the taxpayer intended to sell securities from another lot or instructed a broker to sell securities from another lot.[1]

The following are exceptions to the general rule of adequate identification:

(1) The securities are left in the custody of a broker or other agent. If the seller specifies to the broker which securities to sell or transfer, and if the broker or agent sends a written confirmation of the specified securities within a reasonable time, then the specified securities are the securities sold or transferred, even though different certificates are delivered to the buyer or other transferee;[2]

(2) The taxpayer holds a single certificate representing securities from different lots. If the taxpayer sells part of the securities represented by the certificate through a broker, adequate identification is made if the taxpayer specifies to the broker which securities to sell, and if the broker sends a written confirmation of the specified securities within a reasonable time. If the taxpayer sells the securities, then there is adequate identification if there is a written record identifying the particular securities intended for sale;[3]

(3) The securities are held by a trustee, or by an executor or administrator of an estate. An adequate identification is made if the trustee, executor, or administrator specifies in writing in the books or records of the trust or estate the securities to be sold, transferred, or distributed. In the case of a distribution, the trustee, executor, or administrator must give the distributee a written document specifying the particular securities distributed. Here, the specified securities are the securities sold, transferred, or distributed, even if certificates from a different lot were delivered to the purchaser, transferee, or distributee.[4]

In the case of stock which is inherited, the basis is equal to the value of the stock on the date of the decedent's death (and subject to certain exceptions, including the election to apply the alternate valuation date).[5] Since the new basis is generally equal to the date of death value of the stock, this adjustment can result in either a step up or a step down in basis. Therefore, unrealized gains and losses disappear at the time of death.

8829. What is the accumulated earnings tax that a C corporation may be subject to? When does the tax apply?

In addition to the graduated tax rate schedule outlined in Q 8825, a corporation will be subject to a penalty tax if, for the purpose of preventing the imposition of income tax upon

1. Treas. Reg. §1.1012-1(c)(2).
2. Treas. Reg. §1.1012-1(c)(3)(i).
3. Treas. Reg. §1.1012-1(c)(3)(ii).
4. Treas. Reg. §1.1012-1(c)(4).
5. IRC Sec. 1014, 2032

its shareholders, it accumulates earnings instead of distributing them as dividends.[1] The tax is 20 percent of the corporation's *accumulated taxable income* (15 percent for tax years beginning prior to 2013).[2]

"Accumulated taxable income" is taxable income for the year (after certain adjustments) minus the federal income tax, dividends paid to stockholders (during the taxable year or within 2½ months after the close of the taxable year), and the "accumulated earnings credit."[3]

A corporation is permitted to retain amounts required to meet the reasonable needs of the business—the tax will only be imposed upon amounts in excess of these amounts. To facilitate this permitted retention, an accumulated earnings credit is allowed. A corporation must demonstrate a specific, definite and feasible plan for the use of the accumulated funds in order to avoid the tax.[4]

The use of accumulated funds for the personal use of a shareholder and family is evidence that the accumulation was to prevent the imposition of income tax upon its shareholders.[5] In deciding whether a family owned bank was subject to the accumulated earnings tax, the IRS took into account the regulatory scheme the bank was operating under to determine its reasonable needs.[6]

Most corporations are allowed a minimum accumulated earnings credit equal to the amount by which $250,000 ($150,000 in the case of service corporations in health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting) exceeds the accumulated earnings and profits of the corporation at the close of the previous taxable year.[7] Consequently, an aggregate of $250,000 (or $150,000) may be accumulated for any purpose without danger of incurring the penalty tax.

Tax-exempt income is not included in the accumulated taxable income of the corporation, but will be included in earnings and profits in determining whether there has been an accumulation beyond the reasonable needs of the business.[8] However, a distribution in redemption of stock to pay death taxes which is treated as a dividend does not qualify for the "dividends paid" deduction (Q 8826) in computing accumulated taxable income.[9]

The accumulated earnings tax applies to all C corporations, without regard to the number of shareholders in taxable years beginning after July 18, 1984.[10]

1. IRC Secs. 531-537; *GPD, Inc. v. Comm.*, 75-1 USTC ¶9142 (6th Cir. 1974).
2. IRC Sec. 531, as amended by ATRA.
3. IRC Sec. 535.
4. *Eyefull Inc. v. Comm.*, TC Memo 1996-238.
5. *Northwestern Ind. Tel. Co. v. Comm.*, 127 F. 3d 643, 97-2 USTC ¶50,859 (7th Cir. 1997).
6. TAM 9822009.
7. IRC Sec. 535(c)(2).
8. Rev. Rul. 70-497, 1970-2 CB 128.
9. Rev. Rul. 70-642, 1970-2 CB 131.
10. IRC Sec. 532(c).

8830. What is the personal holding company tax that a C corporation may be subject to? When does the tax apply?

In addition to the typical corporate tax rates (Q 8825) and accumulated earnings penalty tax (Q 8829), a second penalty tax, called the personal holding company (PHC) tax, may be imposed to prevent shareholders from avoiding personal income taxes on securities and other income-producing property placed in a corporation to avoid higher personal income tax rates. The PHC tax is 20 percent (15 percent for tax years beginning prior to 2013) of the corporation's undistributed PHC income (taxable income adjusted to reflect its net economic income for the year, minus dividends distributed to shareholders), if the corporation meets both the "stock ownership" and "PHC income" tests.[1]

A corporation meets the "stock ownership" test if more than 50 percent of the value of its stock is owned, directly or indirectly, by or for not more than 5 shareholders.[2] Certain stock owned by families, trusts, estates, partners, partnerships, and corporations may be attributed to individuals for purposes of this rule.[3]

A corporation meets the "PHC income" requirement if 60 percent or more of its adjusted ordinary gross income is PHC income, generally defined to include the following: (1) dividends, interest, royalties, and annuities; (2) rents; (3) mineral, oil, and gas royalties; (4) copyright royalties; (5) produced film rents (amounts derived from film properties acquired before substantial completion of the production); (6) compensation from use of corporate property by shareholders; (7) personal service contracts; and (8) income from estates and trusts.[4]

8831. Are C corporations subject to the alternative minimum tax? How is the corporate alternative minimum tax calculated?

A corporate taxpayer must calculate its liability under the regular tax and a tentative minimum tax, and then add to its regular tax the amount of tentative minimum tax as exceeds the regular tax. The amount added is the corporate alternative minimum tax (AMT).[5]

To calculate its AMT, a corporation first calculates its "alternative minimum taxable income" (AMTI), as explained below.[6] The corporation must then calculate its "adjusted current earnings" (ACE), also explained below. The corporation increases its AMTI by 75 percent of the amount by which ACE exceeds AMTI (or reduces its AMTI by 75 percent of the amount by which AMTI exceeds ACE).[7] The tax itself is a flat 20 percent rate, applied to the corporation's AMTI after it is adjusted based on ACE.[8]

1. IRC Secs. 541, as amended by ATRA, 542, 545.
2. IRC Sec. 542(a)(2).
3. IRC Sec. 544.
4. IRC Secs. 542(a)(1), 543(a).
5. IRC Secs. 55-59.
6. IRC Sec. 55(b)(2).
7. IRC Sec. 56(g).
8. IRC Sec. 55(b)(1)(B).

Each corporation receives a $40,000 exemption, similarly to the AMT exemption applicable to individuals (see Q 8555). The corporate exemption amount, however, is reduced by 25 percent of the amount by which AMTI exceeds $150,000 (phasing out completely at $310,000).[1]

AMTI is regular taxable income determined with certain adjustments and increased by tax preferences.[2] "Tax preferences" for corporations are the same as for other taxpayers. Adjustments to income include the following:

(1) property is generally depreciated under a less accelerated or a straight line method over a longer period, except that a longer period is not required for property placed in service after 1998;

(2) mining exploration and development costs are amortized over 10 years;

(3) a percentage of completion method is required for long-term contracts;

(4) net operating loss deductions are generally limited to 90 percent of AMTI (although some relief was available in 2001 and 2002);

(5) certified pollution control facilities are depreciated under the alternative depreciation system except those that are placed in service after 1998, which will use the straight line method; and

(6) the adjustment based on the corporation's ACE.[3]

To calculate ACE, a corporation begins with AMTI (determined without regard to ACE or the AMT net operating loss) and makes additional adjustments. These adjustments include adding certain amounts of income that are includable in earnings and profits but not in AMTI (including income on life insurance policies and receipt of key person insurance death proceeds). The amount of any such income added to AMTI is reduced by any deductions that would have been allowed in calculating AMTI had the item been included in gross income. The corporation is generally not allowed a deduction for ACE purposes if that deduction would not have been allowed for earnings and profits purposes, though a deduction is allowed for certain dividends received by a corporation. Generally, for property placed into service after 1989 but before 1994, the corporation must recalculate depreciation according to specified methods for ACE purposes. For ACE purposes, earnings and profits are adjusted further for certain purposes such as the treatment of intangible drilling costs, amortization of certain expenses, installment sales, and depletion.[4]

A corporation subject to the AMT in one year may be allowed a minimum tax credit against regular tax liability in subsequent years. The credit is equal to the excess of the adjusted net minimum taxes imposed in prior years over the amount of minimum tax credits allowable in prior years.[5] However, the amount of the credit cannot be greater than the excess of the corporation's

1. IRC Secs. 55(d)(2), 55(d)(3).
2. IRC Sec. 55(b)(2).
3. IRC Secs. 56(a), 56(c), 56(d).
4. IRC. Sec. 56(g); the tax is reported on Form 4626
5. IRC Sec. 53(b).

regular tax liability (reduced by certain credits such as certain business related credits and certain investment credits) over its tentative minimum tax.[1]

8832. Are there any exceptions to the rule that corporations may be subject to the alternative minimum tax? Can small corporations be exempt from AMT requirements?

Certain small corporations are deemed to have a tentative minimum tax of zero and are, therefore, exempt from the AMT.[2] To qualify, the corporation must meet a $5 million gross receipts test for its first taxable year beginning after 1996, under which average annual gross receipts for the previous three years must not exceed $5 million. If the corporation has not existed for three full years, the years the corporation was in existence are substituted for the three years (with annualization of any short taxable year). The corporation must continue to meet this test in each subsequent tax year to remain exempt, but with $7.5 million substituted for $5 million.[3]

Gross receipts means those receipts properly recognized under the taxpayer's method of accounting for federal income tax purposes. Gross receipts include total sales (net of returns and allowances) and all amounts received for services. It also includes all investment income such as interest, dividends, rents and royalties. Gross receipts are generally reduced by the adjusted basis of capital assets or property sold in a trade or business.[4]

If a corporation loses its AMT exemption, certain adjustments used to determine the corporation's AMTI will be applied for only those transactions entered into or property placed in service in tax years beginning with the tax year in which the corporation ceases to be a small corporation and tax years thereafter.[5]

A corporation exempt from the AMT because of the small corporation provision may be limited in the amount of credit it may take for AMT paid in previous years. In computing the AMT credit, the corporation's regular tax liability (reduced by applicable credits) used to calculate the credit is reduced by 25 percent of the amount that such liability exceeds $25,000.[6]

8833. What is a controlled group of corporations?

The controlled group rules aggregate several entities (this rule applies to corporations, but also to proprietorships and partnerships) into a single employer for meeting various qualification requirements of the IRC. In general, the determination of whether a group is a controlled group of corporations or under common control considers stock ownership by value or voting power. All employees of a group of employers that are members of a controlled group of corporations or, in the case of partnerships and proprietorships, are under common control will be treated as employed by a single employer.[7]

1. IRC Sec. 53(c).
2. IRC Sec. 55(e).
3. IRC Secs. 55(e)(1), 448(c).
4. Treas. Reg. §1.448-1T(f)(2)(iv).
5. IRC Sec. 55(e)(2).
6. IRC Sec. 55(e)(5).
7. IRC Secs. 414(b), 414(c).

A controlled group may be a parent-subsidiary controlled group, a brother-sister controlled group, or a combined group, as follows:[1]

(1) A parent-subsidiary controlled group is composed of one or more chains of subsidiary corporations connected through stock ownership with a common parent corporation. A parent-subsidiary group exists if at least 80 percent of the stock of each subsidiary corporation is owned by one or more of the other corporations in the group and the parent corporation owns at least 80 percent of the stock of at least one of the subsidiary corporations. When determining whether a parent owns 80 percent of the stock of a subsidiary corporation, all stock of that corporation owned directly by other subsidiaries is disregarded;

(2) A brother-sister controlled group is two or more corporations in which five or fewer individuals, estates, or trusts own stock consisting of 80 percent or more of each corporation, and more than 50 percent of each corporation when taking into account each stockholder's interest only to the extent each stockholder has identical interests in each corporation. For purposes of the 80 percent test, a stockholder's interest is considered only if the stockholder owns some interest in each corporation of the group;[2]

(3) A combined group is three or more corporations, each of which is a member of a parent-subsidiary group or a brother-sister group (above) and one of which is both a parent of a parent-subsidiary group and a member of a brother-sister group.[3]

Special rules apply for determining stock ownership, including special constructive ownership rules, when determining the existence of a controlled group.[4] Community property rules, where present, also apply.[5]

For purposes of qualification, the test for a controlled group is strictly mechanical. Once the existence of a group is established, aggregation of employees is required and will not be negated by showing that the controlled group and plans were not created or were manipulated for the purpose of avoiding the qualification requirements.[6]

8834. How is the treatment of transactions between corporations impacted by membership in a controlled group? How are corporate members of a controlled group taxed?

IRC Section 482 allows the IRS to distribute, apportion or allocate income, deductions, credits or allowances among a controlled group of corporations (see Q 8833) in order to prevent tax evasion or to more accurately reflect the actual income of the entity. While the provision

1. Treas. Reg. §1.414(b)-1.
2. *U.S. v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982); Treas. Reg. §1.1563-1(a)(3).
3. IRC Secs. 414(b), 1563; Treas. Reg. §1.414(b)-1.
4. IRC Sec. 1563(d); Treas. Reg. §1.414(b)-1.
5. *Aero Indus. Co., Inc. v. Comm.*, TC Memo 1980-116.
6. Fujinon Optical, Inc. v. Comm., 76 TC 499 (1981).

applies to all entities, it is especially relevant in the context of a corporation that may engage in transactions with other corporations in the controlled group that are not considered to be arm's length. In such a situation, special rules may govern transactions that take place between members of the controlled group.

To reflect the fact that such a sale or exchange between members of a controlled group may not have resulted from arm's length negotiations, loss on a sale or exchange (other than of inventory) between two corporations that are members of the same controlled group (using a 50 percent test instead of 80 percent, see Q 8833), though generally not denied, is deferred until the property is transferred outside the controlled group.[1]

Further, the controlled group rules prevent a single business owner from taking advantage of the graduated rate schedule that applies to corporations through use of multiple corporations that would spread taxable income among corporations in order to cause all income to become subject to the low 15 percent corporate tax rate.[2] Similarly, a controlled group of corporations is entitled to only one accumulated earnings tax credit (Q 8829) and only one $40,000 AMT exemption (Q 8831).[3]

8835. What is an S corporation and how is it formed?

An S corporation is a corporation that files an election to be treated as an S corporation, which, generally, means that it will be treated as a pass-through entity that is taxed similarly to a partnership, thus avoiding most tax at the corporate level.[4] To be eligible to make the election, a corporation must meet certain requirements as to the kind and number of shareholders (Q 8840), classes of stock (Q 8841), and sources of income. However, the decision to be an S corporation is a tax election. Therefore, an S Corporation will be treated the same as any other corporation for purposes of the applicable state corporation law.

An S corporation must be a domestic corporation with only a single class of stock and may have up to 100 shareholders (none of whom are nonresident aliens) who are individuals, estates, and certain trusts. An S corporation may not be an ineligible corporation.

An ineligible corporation is one of the following: (1) a financial institution that uses the reserve method of accounting for bad debts; (2) an insurance company; (3) a corporation electing (under IRC Section 936) credits for certain tax attributable to income from Puerto Rico and other U.S. possessions; or (4) a current or former domestic international sales corporation (DISC). Qualified plans and certain charitable organizations may be S corporation shareholders.[5]

While an S corporation can only have one class of stock, it is permitted to have a second class of stock if the only difference is the ability to vote.[6]

1. IRC Sec. 267(f).
2. IRC Sec. 1561(a)(1).
3. IRC Sec. 1561(a)(2), (3).
4. See IRC Secs. 1361, 1362, 1363.
5. IRC Sec. 1361.
6. IRC Sec. 1361(c)(4).

Planning Point: In order to qualify as an S corporation, an election must be filed in order to be treated as such. These elections are made on IRS Form 2553, and must be made within two months and fifteen days after the effective date of the election. The IRS has recently issued Revenue Procedure 2013-30, which will extend this time period for up to three years for certain situations.

8836. How is an S corporation taxed? When may S corporation income be taxed at the corporate level?

An S corporation is generally not subject to tax at the corporate level.[1] However, a tax is imposed at the corporate level under certain circumstances. When an S corporation disposes of property within 10 years after the S election was made, gain attributable to pre-election appreciation of the property (built in gain) is taxed at the corporate level to the extent such gain does not exceed the amount of taxable income imposed on the corporation if it were not an S corporation.[2] However, ARRA 2009 provides that, in the case of a taxable year beginning in 2011, no tax is imposed on the built in gain if the fifth taxable year of the 10-year recognition period precedes such taxable year.

For S elections made after December 17, 1987, a corporation switching from C corporation status to S corporation status may also be required to recapture certain amounts at the corporate level in connection with goods previously inventoried under a LIFO method.[3]

In addition, a tax is imposed at the corporate level on *excess* "net passive income" of an S corporation (passive investment income reduced by certain expenses connected with the production of such income) but only if the following are true:

(1) The corporation, at the end of the tax year, has accumulated earnings and profits (either carried over from a year in which it was a nonelecting corporation or due to an acquisition of a C corporation).

(2) Passive investment income exceeds 25 percent of gross receipts.

The highest corporate tax rate (currently 35 percent) applies.[4] "Passive investment income" for means rents, royalties, dividends, interest, and annuities.[5] The following items are excluded from the definition of passive investment income for this purpose:

(1) rents for the use of corporate property if the corporation also provides substantial services or incurs substantial cost in the rental business;[6]

(2) interest on obligations acquired from the sale of a capital asset or the performance of services in the ordinary course of a trade or business of selling the property or performing the services;

1. IRC Sec. 1363(a).
2. IRC Sec. 1374.
3. IRC Sec. 1363(d).
4. IRC Sec. 1375(a).
5. IRC Secs. 1362(d)(3), 1375(b)(3).
6. See Let. Ruls. 9837003, 9611009, 9610016, 9548012, 9534024, 9514005.

(3) gross receipts derived in the ordinary course of a trade or business of lending or financing; dealing in property; purchasing or discounting accounts receivable, notes, or installment obligations; or servicing mortgages;[1] and

(4) if an S corporation owns 80 percent or more of a C corporation, dividends from the C corporation to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.[2]

If amounts are subject to tax both as built-in gain and as excess net passive income, an adjustment will be made in the amount taxed as passive income.[3]

Also, tax is imposed at the corporate level if investment credit attributable to years for which the corporation was not an S corporation is required to be recaptured.[4]

Furthermore, an S corporation may be required to make an accelerated tax payment on behalf of its shareholders if the S corporation elects not to use a required taxable year.[5] The corporation is also subject to estimated tax requirements with respect to the tax on built-in gain, the tax on excess net passive income and any tax attributable to recapture of investment credit.[6]

8837. How is the shareholder of an S corporation taxed?

Like a partnership, an S corporation computes its taxable income similarly to an individual, with the exception that certain personal and other deductions are allowed to the S corporation shareholder, but not to the S corporation itself. Further, the S corporation may elect to amortize organizational expenses (see Q 8824).[7]

Each shareholder then reports on his individual return the shareholder's proportionate share of the corporation's items of income, loss, deductions and credits. These items retain their character when they are passed through from the S corporation to the shareholder.[8]

Planning Point: The shareholder receives a Form K-1 from the S corporation every year which states the shareholder's proportionate share of such items. The individual shareholder cannot complete their perosnal income tax return until they receive the Form K-1 from the corporation.

Certain items of income, loss, deduction or credit must be passed through as separate items because they may have an effect on each individual shareholder's tax liability. For example, net capital gains and losses pass through as such to be included with the shareholder's own net capital gain or loss. Any gains and losses on certain property used in a trade or business are passed through separately to be aggregated with the shareholder's other IRC Section 1231 gains and losses. (Gains passed through are reduced by any tax at the corporate level on gains, see Q 8836).

1. Treas. Reg. §1.1362-2(c)(5).
2. Treas. Reg. §1.1362-8(a).
3. IRC Sec. 1375(b)(4).
4. IRC Sec. 1371(d).
5. IRC Sec. 7519.
6. IRC Sec. 6655(g)(4).
7. IRC Sec. 1363(b).
8. IRC Secs. 1366(a), 1366(b).

Miscellaneous itemized deductions pass through to be combined with the individual's miscellaneous deductions for purposes of the 2 percent floor on such deductions. Charitable contributions pass through to shareholders separately subject to the individual shareholder's percentage limitations on deductibility.

Tax-exempt income passes through as such. Items involving determination of credits pass through separately.[1] Before pass-through, each item of passive investment income is reduced by its proportionate share of the tax at the corporate level on excess net passive investment income (see Q 8836).[2]

Items that do not need to be passed through separately are aggregated on the corporation's tax return and each shareholder reports his share of such nonseparately computed net income or loss on the shareholder's individual return.[3] Items of income, deductions, and credits (whether or not separately stated) that flow through to the shareholder are subject to the "passive loss" rule (see Q 8635 to Q 8644) if the activity is passive with respect to the shareholder. Items taxed at the corporate level are not subject to the passive loss rule unless the corporation is either closely held or a personal service corporation.

Thus, whether amounts are distributed to them or not, shareholders are taxed on the corporation's taxable income. Shareholders take into account their shares of income, loss, deduction and credit on a per-share, per-day basis.[4] The S corporation income must also be included on a current basis by shareholders for purposes of the estimated tax provisions.[5]

The Tax Court determined that when an S corporation shareholder files for bankruptcy, all the gains and losses for that year flowed through to the bankruptcy estate. The gains and losses should not be divided based on the time before the bankruptcy was filed.[6]

8838. What special considerations apply in determining a shareholder's basis in S corporation stock?

The basis of each shareholder's stock is *increased* by his share of items of separately stated income (including tax-exempt income), any nonseparately computed income, and by any excess of deductions for depletion over basis in property subject to depletion.[7]

An S corporation shareholder may *not* increase tax basis due to excluded discharge of indebtedness income.[8] The basis of each shareholder's stock is *decreased* (not below zero) by the following:

(1) items of distributions from the corporation that are not includable in the income of the shareholder;

1. IRC Sec. 1366(a)(1).
2. IRC Sec. 1366(f)(3).
3. IRC Sec. 1366(a).
4. IRC Sec. 1377(a).
5. Let. Rul. 8542034.
6. *Williams v. Comm.*, 123 TC 144 (2004).
7. IRC Sec. 1367(a)(1).
8. IRC Sec. 108(d)(7)(A).

(2) separately stated loss and deductions and nonseparately computed loss;

(3) any expense of the corporation not deductible in computing taxable income and not properly chargeable to capital account; and

(4) any depletion deduction with respect to oil and gas property to the extent that the deduction does not exceed the shareholder's proportionate share of the property's adjusted basis.

For tax years beginning after 2005 and before 2014, if an S corporation made a charitable contribution of property, each shareholder's basis was reduced by the pro rata share of basis in the property.[1] If the aggregate of these amounts exceeds the basis in his stock, the excess reduced the shareholder's basis in any indebtedness of the corporation to the shareholder.[2] A shareholder may not take deductions and losses of the S corporation that, when aggregated, exceed the basis in S corporation stock plus his basis in any indebtedness of the corporation to the shareholder.[3] Such disallowed deductions and losses may be carried over.[4] In other words, the shareholder may not deduct in any tax year more than the shareholder has "at risk" in the corporation.

8839. How are S corporation distributions taxed?

Generally, earnings of an S corporation are not treated as earnings and profits. However, an S corporation may have accumulated earnings and profits for any year in which a valid election was not in effect or as the result of a corporate acquisition in which there is a carry-over of earnings and profits under IRC Section 381.[5] Corporations that were S corporations before 1983 but were not S corporations in the first tax year after 1996 are able to eliminate earnings and profits that were accumulated before 1983 in their first tax year beginning after May 25, 2007.[6]

A distribution from an S corporation that does not have accumulated earnings and profits lowers the shareholder's basis in the corporation's stock.[7] Any excess is generally treated as gain.[8]

If the S corporation does have earnings and profits, distributions are treated as distributions by a corporation without earnings and profits, to the extent of the shareholder's share of an accumulated adjustment account (i.e., post-1982 gross receipts less deductible expenses, which have not been distributed).

Any excess distribution is treated under the usual corporate rules. That is, the distribution is treated as a dividend up to the amount of the accumulated earnings and profits. Any excess is applied to reduce the shareholder's basis. Finally, any remainder is treated as a gain.[9] However,

1. IRC Sec. 1367(a)(2), as amended by TEAMTRA 2008 and ATRA.
2. IRC. Sec. 1367(b)(2)(A).
3. IRC Sec. 1366(d)(1).
4. IRC Sec. 1366(d)(2).
5. IRC Sec. 1371(c).
6. SBWOTA 2007 Sec. 8235.
7. IRC Sec. 1367(a)(2)(A).
8. IRC Sec. 1368(b).
9. IRC Sec. 1368(c).

in any tax year, shareholders receiving the distribution may, if all agree, elect to have all distributions in the year treated first as dividends to the extent of earnings and profits and then as return of investment to the extent of adjusted basis and any excess as capital gain.[1] If the IRC Section 1368(e)(3) election is made, it will apply to all distributions made in the tax year.[2]

Certain distributions from an S corporation in redemption of stock are treated as a sale or exchange. Generally, only gain or loss, if any, is recognized in a sale. In general, redemptions that qualify for "exchange" treatment include redemptions that are not essentially equivalent to a dividend, substantially disproportionate redemptions of stock, complete redemptions of stock, certain partial liquidations, and redemptions of stock to pay estate taxes.[3]

If the S corporation distributes appreciated property to a shareholder, gain will be recognized by the corporation as if the property had been sold at fair market value, and the gain will pass through to shareholders like any other gain.[4]

8840. Who can be a shareholder in an S corporation? What restrictions apply to 2 percent shareholders in an S corporation?

An S corporation may have up to 100 shareholders (none of whom are nonresident aliens) who are individuals, estates, and certain trusts.

Members of a family are treated as one shareholder. "Members of a family," for this purpose, means "the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor." Generally, the common ancestor may not be more than six generations removed from the youngest generation of shareholders who would be considered members of the family.[5]

Only certain trusts can qualify as S corporation shareholders. These trusts include: (1) a trust all of which is treated as owned by an individual who is a citizen or resident of the United States under the grantor trust rules; (2) a trust that was described in (1) above immediately prior to the deemed owner's death that continues in existence after such death may continue to be an S corporation shareholder for up to two years after the owner's death; (3) a trust to which stock is transferred pursuant to a will may be an S corporation shareholder for up to two years after the date of the stock transfer; (4) a trust created primarily to exercise the voting power of stock transferred to it; (5) a qualified subchapter S trust (QSST), see below; (6) an electing small business trust (ESBT), see below; and (7) in the case of an S corporation that is a bank, an IRA or Roth IRA.[6] An estate can continue to be an eligible shareholder during the reasonable period of administration. This can continue for the duration of payments being made under Sec. 6166 (relating to the deferral of the estate tax relating to closely held business).[7]

1. IRC Sec. 1368(e)(3).
2. Let. Rul. 8935013.
3. See IRC Secs. 302, 303.
4. IRC Secs. 1371(a), 311(b).
5. IRC Sec. 1361(c)(1).
6. IRC Secs. 1361(c)(2), 1361(d).
7. IRC Sec. 1361(b)(1)(B); Rev. Rul 76-23; Plr 200226031

A QSST is a trust that has only one current income beneficiary (who must be a citizen or resident of the U.S.), all income must be distributed currently, and the trust corpus may not be distributed to anyone else during the life of such beneficiary. The income interest must terminate upon the earlier of the beneficiary's death or termination of the trust. If the trust terminates during the lifetime of the income beneficiary, all trust assets must be distributed to that beneficiary. The beneficiary must make an election for the trust to be treated as a QSST.[1]

An ESBT is a trust in which all of the beneficiaries are individuals, estates, or charitable organizations.[2] Each potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100 shareholder limitation.[3] A potential current beneficiary is generally, with respect to any period, someone who is entitled to, or in the discretion of any person may receive, a distribution of principal or interest of the trust. In addition, a person treated as an owner of a trust under the grantor trust rules is a potential current beneficiary.[4] If there is no potential current beneficiary of an ESBT during any period, the ESBT itself is treated as the S corporation shareholder.[5] Trusts exempt from income tax, QSSTs, charitable remainder annuity trusts, and charitable remainder unitrusts may not be ESBTs. An interest in an ESBT may not be obtained by purchase.[6] If any portion of the basis in the beneficiary's interest is determined under the cost basis rules, the interest is treated as though it was acquired by purchase.[7] An ESBT is taxed at the highest individual income tax rate (39.6 percent in 2013 and beyond).[8]

8841. What restrictions apply to an S corporation's ability to issue stock?

An S corporation must be a domestic corporation with only a single class of stock.

A corporation will be treated as having one class of stock if all of its outstanding shares confer identical rights to distribution and liquidation proceeds.[9] Also, it is permissible to have two classes of stock if the only difference between the two classes is the ability to vote.[10] "Bona fide agreements to redeem or purchase stock at the time of death, disability or termination of employment" will be disregarded for purposes of the one-class rule unless a principal purpose of the arrangement is to circumvent the one-class rule.

Similarly, bona fide buy-sell agreements will be disregarded unless a principal purpose of the arrangement is to circumvent the one-class rule and they establish a purchase price that is not substantially above or below the fair market value of the stock. Agreements that provide for a purchase price or redemption of stock at book value or a price between book value and fair market value will not be considered to establish a price that is substantially above or below fair market value.[11]

1. IRC Sec. 1361(d).
2. IRC Sec. 1361(e).
3. IRC Sec. 1361(c)(2)(B)(v).
4. Treas. Reg. §1.1361-1(m)(4).
5. Treas. Reg. §1.1361-1(h)(3)(i)(F).
6. IRC Sec. 1361(e).
7. Treas. Reg. §1.1361-1(m)(1)(iii).
8. IRC Secs. 641(c), 1(e).
9. Treas. Reg. §1.1361-1(l)(1).
10. IRC Sec. 1361(c)(4).
11. Treas. Reg. §1.1361-1(l)(2)(iii). See IRC Secs. 1361, 1362.

Agreements triggered by divorce and forfeiture provisions that cause a share of stock to be substantially nonvested are disregarded in determining whether a corporation's shares confer identical rights to distribution and liquidation proceeds.[1]

Planning Point: The application of the second class of stock rules can sometimes arise in unexpected situations. For example, employment agreements or buy sell agreements may contain provisions which establish a different purchase/sale price for different shareholders or situations. These contractual rights could potentially be construed to violate the prohibition against having a second class of stock. Therefore, care must be given to the consequences which one agreement may have upon another.

8842. What is a qualified subchapter S subsidiary (QSSS)?

An S corporation may own a qualified subchapter S subsidiary (QSSS). A QSSS is a domestic corporation that is not an ineligible corporation (see Q 8835), if 100 percent of its stock is owned by the parent S corporation and the parent S corporation elects to treat it as a QSSS.

A QSSS is generally not treated as a separate corporation and its assets, liabilities, and items of income, deduction, and credit are treated as those of the parent S corporation.[2] If the S corporation or its QSSS is a bank, special rules provide for the recognition of a QSSS as a separate entity for tax purposes.[3] A QSSS will also be treated as a separate corporation for purposes of employment taxes and certain excise taxes.[4] For tax years beginning after 2014, a QSSS will be treated as a separate corporation for purposes of the shared responsibility payments under the Affordable Care Act.[5]

If a QSSS ceases to meet the above requirements, it will be treated as a new corporation acquiring all assets and liabilities from the parent S corporation in exchange for its stock. If the corporation's status as a QSSS terminates, the corporation is generally prohibited from being a QSSS or an S corporation for five years.[6] In certain cases following a termination of a corporation's QSSS election, the corporation may be allowed to elect QSSS or S corporation status without waiting five years if, immediately following the termination, the corporation is otherwise eligible to make an S corporation election or QSSS election, and the election is effective immediately following the termination of the QSSS election. For example, this rule may apply when an S corporation sells all of its QSSS stock to another S corporation, or an S corporation distributes all of its QSSS stock to its shareholders, and the former QSSS makes an S election.[7]

8843. What is an LLC and how is an LLC formed?

A limited liability company (LLC) is a noncorporate business entity. There are no provisions that provide for LLCs in the IRC, as there are with respect to partnerships and corporations. An

1. Treas. Reg. §1.1361-1(l)(2)(iii)(B).
2. IRC Sec. 1361(b)(3).
3. Treas. Reg. §1.1361-4(a)(3).
4. Treas. Reg. §1.1361-4(a)(7) and §1.1361-4(a)(8).
5. Treas. Reg. §1.1361-4(a)(8)(E).
6. IRC Sec. 1361(b)(3).
7. Treas. Reg. §1.1361-5(c).

LLC is created strictly at the state level with the enactment by the state legislature of an LLC Act or Code.

An LLC, by its nature, provides limited liability for its members, absent personal guarantees. Generally, all members may participate in the management of an LLC. Most state statutes provide that an LLC must have at least two members, although a few states allow one-member LLCs. An LLC is formed by drafting a document called the articles of organization and filing it with the appropriate state agency. This initiating document is similar in scope to a C corporation's articles of incorporation (see Q 8823).

The LLC will also create an operating agreement that generally dictates how the organization will be operated and sets out the rules that govern interaction between its members. The contents of both documents set out the framework for the LLC. The way these documents are drafted becomes especially critical in states that have flexible LLC statutes, since the wording of these documents may determine whether the entity will be classified as a partnership or a corporation for federal tax purposes.

The operating agreement, unlike the articles of organization, generally is not filed with a state agency. The operating agreement is similar in scope to a partnership agreement or limited partnership agreement in that it sets out the rights, duties and responsibilities of the members. It provides the guidelines by which the LLC will operate on a day to day basis.

The contents of the operating agreement have proven crucial in determining whether an LLC lacks a preponderance of corporate characteristics and may be afforded partnership tax treatment. Revenue Procedure 95-10[1] provides valuable guidance in drafting an operating agreement so as to avoid a preponderance of the corporate characteristics. In states with flexible LLC statutes, the IRS will look to the particular LLC's operating agreement in order to determine the existence or nonexistence of the corporate characteristics.

The operating agreement will typically contain provisions relating to:

- name, purpose and term of the LLC;
- names and addresses of the members;
- rights, powers and duties of the members and their scope of authority;
- scope of authority of the managers and how the managers are to be chosen;
- capital contributions of members;
- approval of transactions;
- allocation of income, profits, losses, expenses, equity and distributions;
- compensation of members and/or managers;

1. 1995-3 IRB 20.

- provisions for holding meetings, voting and other formalities;
- how fiscal matters such as books, records, accounting methods, etc., will be handled;
- how interests in the LLC may or may not be transferred;
- limitation of liability and indemnification;
- any other provisions applicable to the operation of the organization.

One of the unique characteristics of an LLC is that it is a business entity that may provide for management by all of its members. Unlike an S corporation, an LLC has no restrictions on the number or types of owners and multiple classes of ownership are generally permitted. Management status may be determined by the particular state's LLC act, but most likely will be determined by the LLC's operating agreement.

Planning Point: It is also possible to structure the entity to be "manager managed." Under this approach, certain individuals are designated to manage the entity. This is analogous to having voting and non-voting stock in the corporate context or with a limited partnership (which is managed solely by its general partner).

If the LLC is treated as a partnership, it combines the liability shield of a corporation with the tax advantages of a partnership (see Q 8810).

8844. How is an LLC taxed? How is it determined whether an LLC is taxed as a partnership or corporation?

An LLC may be treated as either a corporation (see Q 8825), partnership (see Q 8810), or sole proprietorship (see Q 8806) for tax purposes. An *eligible entity* (a business entity not subject to automatic classification as a corporation, see below) may elect corporate taxation by filing an entity classification form, otherwise it will be taxed as either a partnership or sole proprietorship depending upon how many owners are involved. Eligible entities can elect how they would like to be classified for tax purposes on IRS Form 8832.

Certain entities, such as corporations organized under a federal or state statute, insurance companies, joint stock companies, and organizations engaged in banking activities, are automatically classified as corporations. An LLC with only one owner will be considered a corporation or a sole proprietorship. In order to be classified as a partnership, the entity must have at least two owners.[1]

If a newly-formed domestic eligible entity with more than one owner does not elect to be taxed as a corporation, it will be classified as a partnership. Likewise, if a newly-formed single-member eligible entity does not elect to be taxed as a corporation, it will be taxed as a sole proprietorship with its profit and loss being reported on Schedule C of the owner's personal income tax return. Therefore, no separate federal return is required. But even though there

1. Treas. Reg. §301.7701-2.

is no federal return, some states may still require a separate tax return.[1] Also, under most circumstances, a corporation in existence on January 1, 1997 does not need to file an election in order to retain its corporate status.[2]

If a business entity elects to change its classification, rules are provided for how the change is treated for tax purposes.[3]

Revenue Ruling 95-37[4] provides that a partnership converting to a domestic LLC will be treated as a partnership-to-partnership conversion (and therefore be "tax-free") provided that the LLC is classified as a partnership for federal tax purposes. The partnership will not be considered terminated under IRC Section 708(b) upon its conversion to an LLC so long as the business of the partnership is continued after the conversion. Further, there will be no gain or loss recognized on the transfer of assets and liabilities so long as each partner's percentage of profits, losses and capital remains the same after the conversion. The same is true for a limited partnership converting to an LLC.[5]

An LLC formed by two S corporations was classified as a partnership for federal tax purposes.[6] An S corporation may merge into an LLC without adverse tax consequences provided the LLC would not be treated as an investment company under IRC Section 351 and the S corporation would not realize a net decrease in liabilities exceeding its basis in the transferred assets pursuant to Treasury Regulation Section 1.752-1(f). Neither the S corporation nor the LLC would incur gain or loss upon the contribution of assets by the S corporation to the LLC in exchange for interests therein pursuant to IRC Section 721.[7] A corporation will retain its S election when it transfers all assets to an LLC, which is classified as a corporation for federal tax purposes due to a preponderance of corporate characteristics (see below), provided the transfer qualifies as a reorganization under IRC Section 368(a)(1)(F) and the LLC meets the requirements of an S corporation under IRC Section 1361.[8]

An LLC that was in existence prior to January 1, 1997, may continue under its previous claimed classification if it meets the following requirements: (1) it had a reasonable basis for the classification; (2) the entity and its members recognized the consequences of any change in classification within the sixty months prior to January 1, 1997; and (3) neither the entity nor its members had been notified that the classification was under examination by the IRS.[9]

Prior to January 1, 1997, whether an LLC was treated as a corporation or partnership for federal income tax purposes depended on the existence or nonexistence of a preponderance of six corporate characteristics: (1) associates; (2) an objective to carry on a business and divide

1. See instructions for form SS-4.
2. Treas. Reg. §301.7701-3.
3. Treas. Reg. §301.7701-3(g).
4. 1995-1 CB 130.
5. Let. Rul. 9607006.
6. Let. Rul. 9529015.
7. Let. Rul. 9543017.
8. Let. Rul. 9636007.
9. Treas. Reg. §301.7701-3(h)(2).

the gains from it; (3) limited liability; (4) free transferability of interests; (5) continuity of life; and (6) centralized management.[1]

Characteristics (1) and (2) above are common to both corporations and partnerships and were generally discounted when determining whether an organization was treated as a corporation or partnership.[2] These former regulations provided an example of a business entity that possessed the characteristics of numbers (1), (2), (4) and (6) above, noting that since numbers (1) and (2) were common to both corporations and partnerships, these did not receive any significant consideration. The business entity did not possess characteristics (3) and (5) above and, accordingly, was labeled a partnership.[3]

8845. What is a professional service corporation (PSC)? Is there any difference between the tax treatment of C corporations and PSCs?

Organizations of physicians, lawyers, and other professional people organized under state professional corporation or association acts are generally treated as corporations for tax purposes.[4] However, to be treated as a corporation, a professional service organization must be both organized and *operated* as a corporation.[5] Although professional corporations are generally treated as corporations for tax purposes, they are not generally taxed in the same manner as regular C corporations (Q 8825). Note that if a professional corporation has elected S corporation status, the shareholders will be treated as S corporation shareholders (see Q 8835).

Although a professional corporation is recognized as a taxable entity separate and apart from the professional individual or individuals who form it, the IRS may under some circumstances reallocate income, deductions, credits, exclusions, or other allowances between the corporation and its owners in order to prevent evasion or avoidance of tax or to properly reflect the income of the parties.

Under IRC Section 482, such reallocation may be made only where the individual owner operates a second business distinct from the business of the professional corporation. Reallocation may not be made where the individual works exclusively for the professional corporation.[6]

8846. What is a B corporation?

A B corporation is a relatively new type of corporation that has gained popularity in recent years. A "B" corporation, also known as a "benefit corporation," is a corporation that is formed with the express purpose of fulfilling some type of socially responsible mission that is intended to create a general public benefit. Not all states have passed legislation that makes the benefit corporation a separate legal entity that taxpayers can consider in their choice of entity analysis.

1. Treas. Reg. §301.7701-2(a)(1), as in effect prior to January 1, 1997.
2. Treas. Reg. §301.7701-2(a)(2), as in effect prior to January 1, 1997.
3. Treas. Reg. §301.7701-2(a)(3), as in effect prior to January 1, 1997.
4. Rev. Rul. 77-31, 1977-1 CB 409.
5. *Roubik v. Comm.*, 53 TC 365 (1969).
6. *Foglesong v. Comm.*, 82-2 USTC ¶9650 (7th Cir. 1982).

Maryland, California, Hawaii, New Jersey, New York, Vermont and Virginia are among those that have passed legislation.[1]

A B corporation is not a unique type of entity—rather; it is a corporation where the charter provides that it will be operated as a benefit corporation. The charter will typically provide the specific socially responsible purpose that the B corporation exists to fulfill. Essentially, the B corporation's officers and directors will be liable not only for operating the corporation in order to achieve a profit, but also to fulfill the specified social purpose.

Although not required at formation, since a B corporation is essentially formed as a C corporation, several nonprofit groups exist to provide certification, as well as guidance and assistance in determining the public benefit structure of a B corporation. One of these, a nonprofit group called "B Labs" provides an assessment test that the corporation takes in order to determine its social and environmental impact and goals.[2] Once the corporation "passes" this test, as long as it meets all of the legal requirements applicable to validly formed corporations (Q 8823) and signs a declaration that it will operate as a B corporation, it becomes certified.

Some state statutes provide for a cause of action by the B corporation, directly or through its shareholders, against a B corporation's officers and directors for failure to pursue the public benefit purpose that is specified in its charter.[3] Further, state statutes require the B corporation to describe its activities relating to the specified public benefit in its annual report to shareholders. As such, a B corporation is essentially a type of C corporation that is subject to certain additional requirements, which vary by state, related to the performance of some public good.

8847. How is a B corporation taxed?

The IRS has yet to provide guidance as to the tax treatment of B corporations. As such, a B corporation is subject to the same tax rules that govern C corporations (see Q 8822 to Q 8834), until the IRS releases guidance to the contrary.

8848. How might the losses that may be incurred during operation of a business impact choice of entity decisions?

For many business owners, the opportunity to limit personal liability may be the most attractive feature of the corporate form. This can be an advantage and even a necessity for a business that faces substantial liability for the actions of its agents, the hazardous nature of its business, or the liability exposure of its products. Also, any venture has an inherent risk of loss, especially in the early years. Shareholders in a corporation (as well as members of a limited liability company and limited partners in a limited partnership) are not liable for the corporation's actions beyond

1. The nonprofit group that exists to certify B corporation status, "B Labs," provides updates on B corporation legislation as it is passed, available at http://www.bcorporation.net/what-are-b-corps/legislation (last accessed July 30, 2013). Delaware passed its legislation pertaining to B corporations as recently as July 17, 2013, so the rules pertaining to B corporations are still in the very early developmental phases.
2. See "Performance Requirements," available at http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/performance-requirements (last accessed June 5, 2014).
3. See, for example, Article 1 of New Jersey legislation authorizing B corporations, available at http://www.njleg.state.nj.us/2010/Bills/A4000/3595_I1.PDF (last accessed June 5, 2014).

the amount of their capital contribution to the corporation. However, there are still important considerations that must be noted, because limited liability is not absolute.

First, the corporation and its shareholders must follow strict state law requirements relating to shareholder meetings, election of a board of directors, directors' meetings, and other matters of internal governance required by the corporation's articles of incorporation and the state of incorporation's laws. These are not mere formalities—a corporation which fails to follow these rules may lose its status as a corporation and limited liability in a process known as "piercing the corporate veil." However, many states have close corporation statutes relaxing these rules and giving shareholders in a closely held corporation greater freedom to determine their own internal governance.

Second, a shareholder's limited liability may be illusory for bank financing, because most lending institutions demand that stockholders personally guarantee close corporation indebtedness.

Finally, potential incorporators who wish to do business under an umbrella of limited liability can find other ways to do so without incorporating. One way to do so may be to set up a limited partnership with an existing corporation or S corporation as the general partner.

8849. What considerations regarding transferability of interests in an entity should be taken into account when choosing the business entity form?

Free transferability of interests is a factor that must be considered when a business owner is determining which business entity structure to choose. Shares in a corporation may be simpler to transfer than an interest in a partnership or a proprietorship. This can be attractive if, for example, an older shareholder wishes to dispose of his interest to finance his retirement, but younger members want to keep operating the business (see Q 8852 to Q 8872, which addresses issues in business succession planning). A corporation can also be recapitalized to freeze the value of an estate and pass a family business to a younger generation. As is the case with limited liability, free transferability of interests, particularly in a closely held corporation, is not absolute.

First, there may be a limited market for minority interests in a closely-held or family business, even one that is organized as a corporation. Prospective investors may simply refuse to risk being frozen out of management decisions and profits, and may be reluctant to upset the balance of personalities and interests already existing in any company. Second, it may be extremely difficult to value the shares in the business. Third, a sale to an inappropriate shareholder may jeopardize a business's status as an S corporation. The solution to many of these problems is to restrict transferability of shares to those within a family, those approved by all other shareholders, or those who would not jeopardize the business' S corporation election. These restrictions, of course, destroy the same free transferability of interests that some incorporators may find attractive.

Finally, increased prestige and image may be a factor to consider. A new corporation may find it easier to attract bank financing and venture capital than a partnership or proprietorship, even if the shareholders must personally guarantee the debt. This advantage comes, however, at the higher price of establishing a corporation than for a partnership or proprietorship. State filing

fees and attorney and accountant's fees all add to the cost of starting the venture. However, a corporation may amortize its organizational expenses over 60 months from the month in which the corporation begins business.[1]

8850. Can the treatment of employment benefits in an entity structure impact choice of entity?

While S corporations and partnerships are able to offer many of the same employment type benefits, such as qualified pension and profit-sharing plans and accident and health insurance, the tax treatment differs in some cases. Many of the IRC provisions that create tax preferences for employment benefits do so only for plans that provide benefits for *employees*. Partners in a partnership are generally subject to different rules. Rather than being treated as employees, 2 percent shareholders in an S corporation are treated as partners for certain employment benefit purposes.[2]

For example, premiums paid for accident and health insurance paid on behalf of 2 percent shareholders and partners are deductible by the entity, but are includable in the recipient's gross income.[3] This is because in order for premiums paid by the employer on behalf of the recipient to be excludable from that recipient's income, he or she must be considered an employee. For purposes of determining the excludability of employer-provided accident and health benefits, self-employed individuals and certain shareholders owning more than 2 percent of the stock of an S corporation are not treated as employees.[4]

Despite this, sole proprietors, partners, and 2 percent shareholder-employees of an S corporation may generally deduct up to 100 percent of their health insurance premiums on their individual returns.[5]

See Q 8725 to Q 8777 for a discussion of the treatment of various health-related benefits provided in an employment context. Q 8778 to Q 8804 discusses the treatment of various employment "fringe" benefits.

8851. When can estate planning considerations impact a choice of entity decision?

Both C corporations and S corporations may take advantage of opportunities to provide liquidity and reduce estate taxes at a shareholders death. These techniques include:

Section 303 stock redemptions. IRC Section 303, designed to provide liquidity and prevent the forced sale of businesses to pay income and estate taxes, provides that income from certain partial redemptions of stock to pay death taxes will be treated as a sale of stock rather than a dividend. Where stock included in the adjusted gross estate of a shareholder (without regard to family attribution-of-ownership rules) equals a certain percentage of the gross estate, the

1. IRC Sec. 248.
2. IRC Sec. 1372.
3. Rev. Rul. 91-26, 1991-1 CB 184.
4. IRC Sec. 105(g); Treas. Reg. §1.105-5(b).
5. IRC Sec. 162(l).

corporation can redeem from the estate a quantity of stock equal in value to the total of the deceased's federal estate tax, state death taxes, and funeral and administrative taxes.

Gifts of stock. Because corporate ownership is easily divisible, shareholders can give close corporation stock to family members, charities, etc. These gifts can shift income to lower-bracket family members, remove future appreciation from the shareholder's future estate, and even provide an income tax deduction in the case of charitable gifts. S corporation shareholders must take care to insure that such gifts do not jeopardize S corporation eligibility.

Planning Point: When making gifts of stock, it is important to review any shareholders agreements which may exist in order to make sure the stock is transferable in the desired manner. It may be necessary to obtain certain consents from the corporation or other shareholders in order to complete the transfer.

Planning Point: Since, however, it is permissible for an S corporation to issue non-voting stock, estate planning opportunities exist whereby the non-voting stock can be transferred without relinquishing control. Also, since the transferred stock in this context is non-voting, it is entitled to an adjustment to reflect the lower value associated with this type of stock.

Estate freeze techniques. Some shareholders in closely-held corporations may reduce their eventual taxable estate by recapitalizing the corporation to "freeze" the value of stock included in their estates and pass future appreciation on to family members. Interests transferred in this fashion will be treated as gifts and valued according to special valuation rules (see Q 8884).

See Q 8852 to Q 8872 for a discussion of business succession techniques, including buy-sell agreements and redemptions, that may be useful in the small business context.

Planning Point: If, however, an S corporation is going to pass through an estate, consideration should be given as to whether the stock is going to pass into a trust. If so, the trust must qualify as either a QSST or ESBT.