FUNDAMENTALS OF ENTITY SELECTION

FASTFORWARD ACADEMY

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COURSE OVERVIEW

INFORMATION

Assisting a client in choosing the best business structure is a challenging task that requires a combination of skills and knowledge. There is much riding on your ability as a tax professional to help entrepreneurs or existing business select the "perfect form." Not only will this decision affect their ability to achieve their specific business objectives, it will also determine how well their assets are protected.

Later, you will read about a small business owner, Deborah Williams, who receives insufficient help from her first accountant when incorporating her small computer business. It cost her dearly before she finally consulted a different tax professional, someone more knowledgeable in this arena.

This course is designed to provide you with the information you need to be of similar value to your clients. In particular, it focuses on the tax advantages and disadvantages of ***S & C Corporations***, ***LLCs***, ***LLPs*** and ***Sole Proprietorships***. It will target and explore many of the major factors that drive the initial decision of entity selection, as well as special circumstances that arise during the course of doing business.

LEARNING OBJECTIVES

- Recognize how to make an informed decision when recommending and setting up a tax entity
- Determine when an entity change is warranted for specific tax advantages
- Determine the most appropriate business and tax strategies for a particular entity
- Identify methods for advising clients on estate planning concerns

TYPES OF STRUCTURES

INTRODUCTION

Determining the type of business to open is half the battle of an entrepreneur. The choice of business structure will largely determine how a business's income will be taxed. The most popular and familiar legal forms of business are:

- Sole proprietorships
- Limited Liability Companies (LLCs)
- Partnerships
- Corporations

These may look like just a few simple words, but given the different legal and tax considerations associated with each one, they could translate into tens of thousands of dollars to a business's bottom line. Carefully weighing these factors before selecting a type is very often the difference between a business that is wildly successful and one that is just scraping by.

SOLE PROPRIETORSHIP

Sole Proprietorship is a business owned by one person, usually the individual in charge of the day-to-day operations, and has no formal legal structure.

Who'd be a Good Candidate: A sole proprietorship is often the ideal choice for a professional in private practice, a guest house owner, or the owner of a small craft business, for example. For many, the advantages outweigh the disadvantages, as long as the business is carefully managed.

Advantages:

- No additional paperwork is required; owners just start

- Owners don't file corporate income taxes; just a Schedule C with their personal tax return (Form 1040)
- The owner keeps all profits

Disadvantages:

- Sole proprietors assume unlimited liability and are legally responsible for all debts against the business
- Business and personal assets are, from a tax standpoint, considered the same, therefore both are at risk if the owner is sued or taxed or if creditors come calling
- Sole proprietorships are difficult for partners to buy into
- Tax consequences may result from later converting a sole proprietorship to a corporation or an LLC

> The most common business structure, sole proprietorships account for more than 70 percent of all businesses in the US, according to U.S. Census data[1]. Yet these business owners are also only making a fraction of the net income that corporations are making, and therefore aren't the best choice for every entrepreneur.

PARTNERSHIPS

A partnership is ***a business with two or more owners who actively engage in the management of the company and divide profits.***

Who'd be A Good Candidate? When two or more people elect to conduct business together, a general partnership is a relatively easy form of business to set up. Forming a partnership, especially when only two individuals are involved, is often done through a verbal agreement but it is important to create a valid, written partnership agreement as soon as possible.

Advantages:

- Partnerships are easy to establish since anyone, or any entity, can be a partner
- No double taxation; profits and losses flow directly through to the partners' personal tax returns
- Offer different classes of ownership shares
- Able to distribute property to partners in a tax-deferred manner

Disadvantages:

- Partners are jointly and individually liable for the actions of the other partners, whether they knowledgeably or knowingly obligate the business
- Profits must be shared
- Some employee benefits are not deductible from business income on tax returns
- Earnings of partners are subject to self-employment taxes
- Flexible structure can complicate accounting and tax preparation preparing

> ***It's Never Too Late to Convert!*** When C corporations have sustained significant declines in asset value, and have become dependent on attracting additional capital or financing, it may prove beneficial for the business to convert to a partnership. This conversion will provide significant tax benefits to the current owners by triggering a tax loss with respect to their interests.

TWO CLASSIFICATIONS OF PARTNERSHIP

Partnerships are formed under state partnership statutes. Essentially, there are two (2) broad classifications of partnerships.

General Partnerships (GP)

In general partnerships, partners divide responsibility for management and liability, as well as the shares of profit or loss according to their internal partnership agreement. Equal shares are assumed unless there is a written agreement that states differently.

> GPs are not required to file a partnership agreement with the state.

Limited Partnerships (LP)

In this type of partnership, there are two types of partners: (1) general partners and (2) limited partners. The designation "limited" simply means that some partners have limited liability (to the extent of their investment) as well as limited input regarding management decisions. This type of arrangement generally encourages investors for short term projects, or for investing in capital assets.

> This form of ownership is not often used for operating retail or service businesses. It's generally seen as more suitable for companies that invest in real estate

Advantages

- Limited partners have limited personal liability for business debts
- General partners can raise cash without involving outside investors in management of business

> Liability for a general partner in an LP can be reduced by forming a corporation or LLC, which would serve as a general partner of the LP. Using this approach, the liability of the general partner is compartmentalized in a limited liability entity, and limited liability protection is achieved. This may explain why many LPs are organized using LLCs or corporate general partners.

OTHER TYPES OF PARTNERSHIPS

Qualified Joint Venture

Spouses that conduct a business together and share in the profits and losses are generally classified as a partnership for federal tax purposes. Previously, married individuals in a business together were considered partners and required to file an annual Form 1065, as well as Form 1040.

How's this done? (1) Income and losses from the business are reported on **Form 1065**; (2) Each spouse then carries their share of the partnership income or loss from **Schedule K-1** to their joint or separate **Form(s) 1040**; (3) All income, gains, losses, deductions, and credits, under this elect tax treatment are then divided based on each spouse's interest in the partnership.

Couples may elect out of partnership reporting, and opt for treatment as a qualified joint venture. For tax years beginning after December 31, 2006, the Small Business and Work Opportunity Tax Act of 2007 (Public Law 110-28) provides that a "qualified joint venture," whose only members are a married couple filing a joint return, can elect not to be treated as a partnership for federal tax purposes.

A qualified joint venture conducts a trade or business where:

- the only members of the joint venture are a married couple who file a joint return
- both spouses materially participate in the trade or business (mere joint ownership of property is not enough)
- both spouses elect not to be treated as a partnership, and

- the business is co-owned by both spouses (and not in the name of a state law entity, such as a partnership or LLC)

The QJV option simplifies the filing requirements by allowing a married couple to treat the business as sole proprietorships and file a Form 1040 federal tax return rather than a partnership for tax purposes. It eliminates filing a Form 1065 tax return for qualified joint ventures. The option also helps to ensure each spouse gets proper Social Security credit. Spouses electing qualified joint venture status are treated as sole proprietors for federal tax purposes.

For example:

- Each spouse has a 50% membership in a partnership which has an income of $100,000, expenses of $70,000, and profit of $30,000.
- A Schedule C is prepared for each spouse, showing $50,000 in income, $35,000 in expenses, and $15,000 in profit.
- The total profit of $30,000 is shown as Business income or (loss) on Form 1040, with the two Schedule C forms as supporting documents.

> In a study by the author of the best-seller, ***The Successful Business Plan: Secrets & Strategies***, Rhonda Abrams claims as many as one-third of today's start-up enterprises are co-owned and co-managed by entrepreneurs, who are also partners in their personal lives.

Family Partnerships

While the IRS allows family members to be partners, it does place some limits on "keeping it in the family." The IRS will only recognize family members (or any other persons) as partners, if one of the following is met:

- If capital is a material income-producing factor, they must have (1) acquired this capital interest in a bona fide transaction (including gift or purchase), and (2) have actually owned and controlled the partnership interest.
    - Capital is considered a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital.
- If capital is **not** a material income-producing factor, they must have (1) joined in good faith to conduct business, (2) agreed that contributions of each entitle them to a share in the profits, and (3) each provided some capital or service.
    - Capital is not a material income-producing factor if business income consists primarily of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.
- If a family member receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is subject to the following two restrictions:
    - It must be figured by reducing the partnership income by reasonable compensation for services the donor renders to the partnership.
    - The donee's distributive share of partnership income from donated capital must not be proportionately greater than the donor's share from the donor's capital.

LIMITED LIABILITY COMPANY (LLC)

An LLC is a hybrid business structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership.

The formation of an LLC, however, is more complex and formal than that of a general partnership.

Who'd be A Good Candidate? The rules regarding a sole proprietor's liability change completely with an LLC, making it a viable option for those wanting more flexibility when it comes to income creation, profits, and liability options.

Advantages:

- Owners have limited personal liability for business debts even if they participate in management

- Can be recognized as a pass-through tax entity
- Can choose to be taxed as a partnership or corporation
- Profits can be distributed differently
- Offers flexibility for tax planning and rewarding employees who bear more responsibilities

Disadvantages:

- LLC laws vary by state
- Sometimes limited in the number of owners (investors)
- Some states do not permit international investors

What Else to Remember About LLCs:

- May elect classification for federal income tax purposes (not legal) as a partnership, a corporation, or a disregarded entity (not separate) from its owner.
- Treated as a corporation for employment tax purposes if has employees.
- An LLC with **two or more owners** will be classified as a **partnership** and an LLC with only **one owner** (a single-member LLC) will be **disregarded** as an entity separate from its owner, ***unless an election is made to treat the LLC as a corporation***.[2]

> **IMPORTANT DEADLINE:** an LLC may select an alternative treatment no more than two months and 15 days after the beginning of the tax year the election is to take effect, or anytime in the preceding tax year. An LLC may elect treatment as an S corporation by filing **Form 2553** or as a corporation by filing Form **8832**. The 60-month limitation rule does apply.[3]
>
> Relief for a late election may be available if the taxpayer can show that the failure to file on time was due to reasonable cause (Rev. Proc 2013-30). It is important to know that Rev. Proc. 2013-30 relief is only for late elections that would otherwise be valid. The procedure allows relief in making the election for up to 3 years and 75 days of the effective date of the election. This procedure for relief does not change the requirement to file the election under 26 U.S. Code § 1362 no later than 2 1/2 months after the beginning of the tax year the election takes effect.

CORPORATIONS

A corporation is a person, or group of people, incorporated by charter by the state in which the entity is headquartered.

A considered by law to be a unique entity, separate and apart from those who own it, a corporation can be taxed and sued and can enter into contractual agreements. Owners of the corporation are its shareholders.

Who'd be A Good Candidate? Any business that needs to raise capital will most likely choose a corporate or LLC business structure because they both allow for a wide variety of financing options.

2 TYPES OF CORPORATIONS: "C" CORPORATIONS AND "S" CORPORATIONS

C Corporations

The C corporation is the "standard" corporation.

Advantages:

- Limits the liability of its shareholders, if adequately capitalized and proper corporate formalities are followed
- No limit on the number of people who can own stock (unlike an S corporation)
- Multiple classes of stock issuances are permitted
- Shareholders can easily trade publicly held shares

- No shareholder-level tax on undistributed income
- Reduced rate of capital gains taxation on sale of qualified small business stock (thanks to IRC §1202)
- Allows ordinary loss deductions in situations of a small business corporation failure (compliments of §1244)

Disadvantages:

- Double taxation
- Lack of rate differential for capital gains
- Potential of tax traps, like personal holding company tax[4] and accumulated earnings tax[5]
- Shareholder unease over gains triggered at corporate level when distributions of appreciated property occur
- Operating losses do not pass through to shareholders

> **C corporations are dropping in popularity.** When you think of C corporations, think big... GM, IBM, and 3M big; big taxes, big administrative costs, and big targets for lawsuits. By comparison, business entities like sole proprietorships, S corporations, and limited liability companies are designed for freelancers and small businesses, as well as businesses not looking to raise capital in the public markets.

S Corporations

The S corporation is a type of corporation that is largely known for permitting pass-through taxation.

What's the Catch? Well, the shareholder, if working for the company, and if there is a profit, must receive wages that meet standards of "reasonable compensation". This varies by geographical region as well as occupation, ***but the basic rule is that the shareholder receives at least what they would pay someone else, as long as there is enough profit***.

> If compensation is not reasonable, the IRS can reclassify all of the earnings and profit as wages, and the shareholders are liable for all of the payroll taxes on the total amount. Joly vs. Commissioner, 211 F.3d 1269 (6th Cir., 2000)

S corporations must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee. The amount of reasonable compensation will never exceed the amount received by the shareholder either directly or indirectly.

Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for the service rendered to the corporation.

Several court cases support the authority of the IRS to reclassify other forms of payments to a shareholder-employee as a wage expense and subject to employment taxes.

Reinforced Employment Status of Shareholders

Two court cases uphold the position of the Internal Revenue Service that shareholders who provide services to the corporation and are entitled to compensation for those services are employees and should be treated as such for federal tax purposes.

Veterinary Surgical Consultants, P.C. v. Commissioner of Internal Revenue, 117 T.C. 141 (2001)

The federal tax court needed to decide if Kenneth K. Sadanaga, D.V.M. was an employee for the period in question for the purposes of federal employment taxes. In making its determination, the court looked at the hours Dr. Sadanaga worked for the petitioner Veterinary Surgical Consultants, how much money he made for the petitioner, and whether or not Dr. Sadanaga performed substantial services for the petitioner. The court noted that Dr. Sadanaga worked approximately 33 hours per week for the petitioner and that the petitioner's only revenue was from the work that Dr.

Sadanaga performed on its behalf. While the petitioner classified the money it paid to Dr. Sadanaga as a distribution of its net income, the court stated that the payments were to be considered remuneration for services rendered to the petitioner by Dr. Sadanaga. The court stated:

Regardless of how an employer chooses to characterize payments made to its employees, the true analysis is whether the payments represent remuneration for services rendered.

The court also found that, as the petitioner's sole full-time worker, Dr. Sadanaga needed to be treated as an employee for federal tax purposes, and that the monies paid to him during the period in question were, in fact, wages.

In general, the tax code allows relief from employment tax liability under §530(a)(1) of the Revenue Act of 1978 if two conditions are satisfied.

A. For purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and
B. In the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee,

then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

The court further stated that Dr. Sadanaga only met one of the conditions: that he was not treated as an employee for any period. The petitioner had filed its tax returns reflecting all withdrawals from Dr. Sadanaga as distributions of petitioner's income, not wages. However, the court was quick to point out that the second section of §530(a)(1) was not satisfied because the petitioner had no reasonable basis for not treating Dr. Sadanaga as an employee.

Joseph M. Grey Public Accountant, P.C. v. Commissioner, 119 T.C. 121 (2002)

Similarly, Joseph M. Grey was the petitioner's sole shareholder and president. Grey performed a wide range of duties for the petitioner, which made him an employee in the eyes of the court and prevented the petitioner from receiving relief under §530.

Generally, if the S corporation is named after someone (i.e. "Joseph M. Grey Public Accountant, P.C."), it's very likely that the named person is performing the work of an employee for the S corporation and should be treated as such for federal tax purposes.

The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. As such, we need to look to the source of the S corporation's gross receipts.

The three major sources are:

- Services of shareholder,
- Services of non-shareholder employees, or
- Capital and equipment.

If the gross receipts and profits come from the last two sources, then that should not be associated with the shareholder-employees personal services and should not be allocated as compensation.

On the other hand, if most of the gross receipts and profits are associated with the shareholders' personal services, then most of the profit distribution should be allocated as compensation.

Some factors in determining reasonable compensation:

- Training and experience
- Duties and responsibilities
- Time and effort devoted to the business
- Dividend history

- Payments to non-shareholder employees
- Timing and manner of paying bonuses to key people
- What comparable businesses pay for similar services
- Compensation agreements
- The use of a formula to determine compensation

Advantages of S Status:

- Avoid double taxation
- Limits employment taxes to reasonable salaries drawn by owners
- Losses, up to the shareholder's basis may offset income from other sources
- Owners limit personal liability

Disadvantages:

- Can't distribute profits unevenly as with LLCs
- Fringe benefits limited for owners who own more than 2% of shares
- Number of shareholders limited to 100
- Limited to one class of stock (through voting and non-voting shares allowed)

So what's up with the "S"? An S corporation gets its name because it is defined in Subchapter S of the Internal Revenue Code. To elect S corporation status when forming a corporation**, Form 2553** must be filed with the IRS and all S corporation guidelines met.

Important Checklists

To be classified as an S corporation, an entity must meet all the following tests:

- Must be a small business corporation
- Have no more than 100 shareholders (family members are treated as one shareholder)
- All shareholders are individuals, estates, exempt organizations, or certain trusts (not partnerships or corporations)
- Have no nonresident alien shareholders
- Have only one class of stock

> The Tax Cuts and Jobs Act (TCJA) expands qualifying beneficiaries of an electing small business trust (ESBT), effective January 1, 2018. An ESBT may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation, but the TCJA, allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

The following are ineligible for S corporation status:

- A bank or thrift institution that uses the reserve method of accounting
- An insurance company subject to tax
- A corporation that has elected to be treated as a possessions corporation
- A domestic international sales corporation (DISC) or former DISC

A parent S corporation can elect to treat an eligible wholly-owned subsidiary as a qualified subchapter S subsidiary. If the corporation makes this election, the subsidiary's assets, liabilities, and items of income, deduction, and credit generally are treated as those of the parent.

Table 1–1: Summary of Entity Differences and Similarities

	Personal liability for business debts	Who can legally obligate the business	Who is responsible for management decisions	Ownership Restrictions	Limits on transferability of interests	Effect of death / departure of owner on business	Taxation of business profits
Sole Proprietorship	Sole Proprietor is personally responsible	Sole Proprietor	Sole Proprietor	Only one sole proprietor allowed	Can sell business to another Party	Automatic dissolution	Individual tax rate of sole proprietor
General Partnership	General partner(s) personally liable	Any General Partner	General Partners	At least two General Partners	Consent of all partners may be required	Automatic dissolution unless provided for in the Limited Partnership Agreement	Individual tax rates of general partners
Limited Partnership	General Partner(s) personally liable; limited partners no personal liability	Any General Partner (not limited)	Any General Partner (not limited)	One General Partner and one limited partner required	Consent of all limited partners may be required (if applicable)	Automatic dissolution unless provided for in Limited Partnership Agreement	Individual tax rates of general and limited partners
Limited Liability Company	No personal liability of members	A member where member-managed; a manager where manager-managed	A member where member-managed; a manager where manager-managed	Most states allow single-member LLCs	Unanimous or supermajority consent may be required by non-transferring member(s)	Some states require dissolution, unless member(s) vote to continue the LLC	Individual tax rates of member(s) unless LLC elects corporate taxation
C Corporation	No personal liability of shareholder(s)	Officers and Directors	Officers and Directors	Most states allow one shareholder, some require two or more shareholders	Transfers may be limited by agreement or by securities law	Corporation continues	Tax paid at corporate level then tax is paid on distributions by shareholders

S Corporation	No personal liability of shareholder(s)	Officers and Directors	Officers and Directors	No more than 100 shareholders; no foreign entities or individuals or domestic entities	Transfers may be limited by agreement or by securities law; transfers to non-qualified persons	Corporation continues	Corporate profits taxed at individual shareholder(s) rate

PICKING THE RIGHT BUSINESS ENTITY

HOW CHALLENGING CAN IT REALLY BE?

> Just ask ***Deborah Williams*** of Amherst, N.Y. When it comes to corporate structure, Deborah Williams has seen it all. Her company, Black Cat Computer Wholesale, has passed through three different corporate forms in just five years. The business began as a sole proprietorship, and then changed to an S corporation, and most recently switched to C corporation status. Williams admits that selecting the correct form for her $7-million company "has been a nightmare, mainly because we grew so quickly that it was tough to figure out just what structure made sense for us."

"I'm an entrepreneur, not an accountant or an expert in corporate structure," she says. "I relied on the advice of accountants who really weren't qualified to advise a fast-growing company." Williams and her current accountant have spent several years undoing mistakes that could have been avoided with good planning and sound advice.

Williams is not alone. Decisions about choosing a new corporate structure are technical and complex, but they can have far-reaching consequences. Business owners can achieve important results by changing their companies' corporate form--or by using new structures in future ventures. "I see clients all the time who come in and don't even want to think about this--all they want is for me to tell them quickly what's the best corporate form for them," notes Bob Franske, director of an accounting firm for small-business in Minneapolis. "But there's no quick answer to that question, even though I have a personal preference for S corps for start-ups. We absolutely need to discuss their goals and all kinds of other issues." Issues like handling ***payroll***, ***self-employment tax***, ***profits & losses*** and ***distributions***.

Williams never had these conversations with her accountant, and she paid the price: avoiding double taxation actually cost her money, and a lot of it. Had she known more about the advantages of C corporations back then, she might well have avoided this common pitfall of first-time business owners.

Williams' story also underscores the importance of having a clear understanding of a client's business objectives so as to provide them with effective tax planning.

CONSIDERATIONS WHEN SELECTING AN ENTITY

Some important points to consider when determining which entity works best for a business include the following:

What is the size and scope of the business?

How many owners are there? Does the business have employees? Are these numbers expected to grow? The size of the business and the number of employees involved is important when selecting a business structure. A business with several full-time employees, for example, may be better as a corporation since corporations are treated more favorably from a benefits perspective.

What is the nature of the business?

Is the business in an industry prone to lawsuits? Is there a great deal of equipment or inventory involved? How important is the level of employee talent, skill, or experience to the venture's success? Each structure has different tax and liability implications. A corporation and an LLC, for example, offer limited liability protection to its owners, while the sole proprietorship and the partnership do not. A corporation can allow for stock options, and other incentives to attract and retain talent.

How much financing will the venture need for start-up, operations, or growth?

Is the business currently making a profit? If there is access to financing, or if the amount of financing that is required is relatively small, then the simple structures, the sole proprietorship, the partnership, the LLC, or an S corporation may be more appropriate. From a tax perspective, a partnership is more appropriate for entities that expect several years of tax losses, as those losses flow through to the shareholders and may be used to offset other income. A corporation, on the other hand is better suited for companies that may need to access the capital markets or those that desire to trade publicly on a stock exchange.

Where is the business holding in its development cycle?

Is the venture in the start-up phase? Is it a new business, or a growing business? Will there be an immediate need for reinvestment in the business, or in the future? These factors can impact business financing and tax needs which can influence the decision on a business structure.

What are the needs of the owners?

Will owners need access to profits? How much structure and control do they want? Business owners should be aware of what each structure will offer them in terms of taxes, liability protection, and control over the business.

What are the tax implications of each structure on the business and on the owners?

Different structures can affect personal taxes and business taxes significantly. A well-informed accountant or business owner will know how to pick a business structure to maximize the situation. A corporation, for example, may be able to save on taxes by reinvesting funds back into the business.

Table 2-1: Nontax Characteristics of Business Entities

	Must formally organize with state	Responsibility for liabilities of business	Legal arrangements among owners	Suitable for initial public offering
Sole Proprietorship	No	Owner	Not Applicable	No
Partnership	No	General Partner(s)	Flexible	No
LLC	Yes	Entity	Flexible	No
Corporation	Yes	Entity	Not Flexible	Yes

TAX CONSIDERATIONS

For tax purposes, a business can be classified either as a ***separate taxpaying entity*** or as a ***flow-through entity***. While there are several types of legal entities, only four general categories are recognized by the US tax system. Briefly, they are:

- Taxable corporations (separate taxpaying entities)
- S corporations (flow-through entities)
- Partnerships (flow-through entities)
- Sole proprietorships (flow-through entities)

Tax advisors must carefully evaluate whether tax rules that apply to a particular classification would be more or less favorable than rules under alternative tax classifications when determining which entity will work best for their client.

Because each business situation is unique, a thorough examination of the treatment of key tax characteristics is required.

Let's Test Your Knowledge!

Question 2-1: Mr. Fudd decides to form his business ACME Big Guns, as an LLC, with only one class of ownership rights. ***If he is the only member***, ***what are Mr. Fudd's*** options for classifying his company for tax purposes?

Answer: Mr. Fudd may treat the business as a taxable corporation, an S corporation, or as a sole proprietorship. ACME Big Guns can be treated as a taxable corporation because incorporated entities may elect to be taxed as corporations. ACME Big Guns is also eligible to make an S election, after electing to be treated as a corporation.

Table 2-2: Business Entities with the Most Favorable Tax Characteristics

Tax Characteristic:	Sole Proprietorship	Entities Taxed as Partnerships	S Corporations	Taxable Corporations
Limitations on number & type of owners	X		X	
Contributions to entity		X	X	X
Double taxation				X
FICA or self-employment taxes	X	X	X	X
Distributions		X	X	X
Selling ownership interest		X	X	X
Liquidating entity		X	X	X
Converting to other entity types	X	X	X	X

There are ***existing entity default*** settings that can also dramatically affect the issue of an entity's taxation.

By default, an unincorporated domestic entity with at least two members is taxed as a partnership. An unincorporated domestic entity with only one member is automatically disregarded as an entity separate from its owner.[6] In an attempt to cut costs, some clients may attempt to set up an entity with do-it-yourself kits before seeking the advice of a professional. Therefore, it is important to have a thorough conversation with your client regarding what has and has not been done.

What is the default tax classification of ACME Big Guns now?

Question 2-2: Mr. Fudd forms ACME Big Guns as a LLC, but allows others to become members in return for contributions of cash, property or service to ACME Big Guns.

Answer: The default tax classification for unincorporated entities with multiple owners is a partnership.

WHEN DOES MAKING A CHANGE MAKE GOOD SENSE?

Let's face it, there is no slam-dunk when it comes to entity selection. What may have worked for a business today, may not work tomorrow. While the client (and you) may think there's value in an entity already in place, it's not always that simple. You may quickly find that you need to quantify the costs versus the benefits of restructuring the existing entity, especially if a revised structure would aid the tax and business planning, and improve the overall development of the business.

Specific reasons to change business structure may include:

- ***Reducing personal risk exposure*** - a sole trader, for example, faces unlimited liability for any debts the business may run-up. Restructuring the business as a limited company will limit liability.
- ***Raising more capital*** - cash injections are generally only possible if you offer an investor a piece of the business in return, which may require you to create shares in the business.
- ***Share responsibilities & risks of ownership*** - for example, taking on a partner can reduce the burden and provide you with cover when you're sick or away.
- ***Planning for retirement or selling business*** - certain structures may be more attractive for potential buyers, e.g. shares in a business are easily transferable so ownership may change but the business continues. Sole proprietorship or partnerships may dissolve on death - ownership of a limited company may be more readily distributed to family members.
- ***Rewarding employees*** - employee share ownership plans only work within a business structure that allows you to create and distribute shares, i.e. a limited company.
- ***Reacting to changes*** - business may not be working, for example, due to changes in the marketplace or may need to adapt to emerging technologies.

ENTITY SELECTION IS ONGOING

That's why it's important to view entity selection as an ongoing endeavor, one that requires continual thought and re-evaluation in light of details about the entity in question and changes in law and statute. The first step is to remind clients of this fact too, reassuring them that you're in place to find the structure that best suits their overall tax issues, and that this may change over time.

OPTIONS, OPTIONS, OPTIONS

In many cases, more than one business structure may seem suitable. This is when narrowing down the choices requires asking further questions about the business.

When may an LLC be a better option than a partnership, S or C corporation in terms of taxation?

(A): To determine the best option, start with these questions. Owners forming an LLC have several options regarding the tax treatment of an entity. Single-member LLCs can elect sole proprietorship, a C corporation, or an S corporation for income tax purposes, while an LLC with multi-members could elect to be taxed as a partnership, C corporation, or an S corporation.

What are self-employment taxes likely to be?

(A): If the LLC is actively involved in trade or business and self-employment taxes are high for the owner(s), an S corporation may be best. But remember not every business is going to be eligible for S corporation status.

Will the entity be holding real estate or other passive investments?

(A): LLCs holding real estate or other passive investments may find that the S or C corporation is not a good choice, as the corporation may create an extra level of taxation.

Do the owner(s) intend to do business in more than one state?

(A): LLCs actively engaged in trade or business in more than one state may find that a C corporation will assist in reducing the multi-state income tax accounting burden.

EXPLORE ALL POSSIBLE ADVANTAGES

The advantages to forming certain entities are more transparent than others. Other "hidden" advantages may require a little more digging on your part. Again, examine every aspect and consider creating an exhaustive list of possible best and worst scenarios, which can go a long way toward ensuring you are presenting the client with the best options available given current circumstances.

DEALING WITH OPERATIONAL ISSUES

EMPLOYEE COMPENSATION TAX ISSUES

The structuring of compensation has both tax and non-tax effects depending on entity choice.

> For ***sole proprietors***, all income flowing through the business is subject to self-employment tax. At the other end of the spectrum, corporate stockholders can be treated and compensated as employees, subject to payroll tax withholding

What's Self-Employment Tax? According to the IRS, Self-Employment (SE) tax is "social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners." The 2021 SE tax rate is 15.3%. The rate consists of two parts: 12.4% for social security and 2.9% for Medicare.

CLOSER LOOK AT OTHER ISSUES BY ENTITY TYPE

Partnerships

> **IRC §1402(a)** states that for employment tax purposes, a general partner is subject to self-employment tax on all partnership income, whereas under ***§707(c)***, a limited partner is liable for self-employment tax only with respect to guaranteed payments for services rendered to the partnership.

> In some cases, classification as a self-employed taxpayer may prove preferable as deductions for business expenses of self-employed workers are above-the-line deductions under §62(a)(1).

LLCs

Whether or not LLC owners are subject to payroll depends on ***the treatment of the entity***.

Let's Look at 2 Scenarios:

(1) Single-Member Entities Treated as Disregarded Entities

- A single-member LLC (or a one-owner LLC) engaged actively in trade or business **IS** required to pay self-employment tax on its profits.
    - Business income is reported on a **Schedule C tax form** and self-employment tax is calculated on a Schedule SE tax form.
- A single-member LLC not engaged in an active trade or business **DOES NOT** pay self-employment tax on its profits.
    - An example of this would be an LLC engaged in a passive activity such as real estate investing. These types of single-member LLCs would report passive income on a **Schedule E**.

(2) Multiple-Member LLCs Treated as Partnerships

- The owners or partners in a multiple-member LLC engaged in an active trade or business **DO** pay self-employment tax on their shares of the profit.
    - Business income is reported on a separate **Form 1065 partnership tax return**, and individual owner/partner income is reported on their **Form 1040 individual tax return**.
- If members are not engaged in active trade or business, then the LLC owners/partners **DO NOT** pay self-employment tax on their portion. Partnership profits are then reported on each owner/individual's respective Schedule E.

LLCS TREATED AS C CORPORATIONS

The profits of an LLC that has elected to be treated as a C corporation are not subject to self-employment tax but are subject to corporate income tax as reported on the **LLC's Form 1120 Corporation Income Tax Return**.

Corporate profits distributed to owners in the form of dividends are taxed again at the ***15% qualifying dividend rate***. These entities would however pay payroll tax on any wages paid to LLC members working in the business.

LLCS TREATED AS S CORPORATIONS

Profits of an LLC treated as an S corporation are not subject to either self-employment or corporate income taxes. The entity will need to file a **Form 1120S**, through which the LLC's owners will be taxed on their individual shares of the corporation's profit. ***LLC owners working in this type of business entity are expected to be paid a reasonable wage, and on those wages, the LLC will owe payroll taxes.***

Corporations

The number of stockholders, and their involvement in the corporation's business, has a big impact on the structure of compensation.

A sole-stockholder C corporation, for instance, will typically structure compensation to reduce taxable income at the corporate level to reduce the stockholder's future exposure to double taxation. A single-stockholder of an S corporation, on the other hand, may structure compensation to increase corporate taxable income, allowing income to pass through to the stockholder, thus reducing exposure to Social Security taxes.

As tax advisors need to be concerned with the ***reasonableness of compensation***. The question for C corporations is whether the stockholder/employee's salary is too high in relation to any dividends paid. For S corporations, it's if the stockholder/employee's salary is too low in relation to distributions.

What's the fall-out? For S corps, it can be severe. Set the salary too low and they run the risk of an IRS examination. That's bad! Really bad. In an audit, a too-low salary means not only that the corp will be required to pay back the S corporation tax savings it thought it was getting, but it also means the corp will be assessed severe penalties. Ouch!

Set the salary too high, however, and a major benefit of the S election is lost. The S corp may needlessly overpay payroll taxes. And overpaying payroll taxes can be an expensive mistake over the course of a business's life. Double-ouch!!

DETERMINING COMPENSATION

Setting reasonable compensation requires an examination of several factors.

For C Corporations:

- Compensation paid in proportion to stock ownership
- Dividend history
- The corporation's capital structure
- Year-end increases in salary
- Existing employment agreements
- Statistical reasonableness of compensation based on the company's sales
- Industry' guidelines
- Loan covenants

For S Corporations:

- Services performed in relation to salary
- Number of employees
- Degree of control over corporations
- Undocumented loans received
- Existence of employment agreement
- Compensation level of other employees
- Industry guidelines
- Loan covenants

> Under an S corporation, a shareholder's pro-rata share of the earnings is not subject to the self-employment tax. However, a shareholder who is an officer performing substantial services may be considered an employee, and as an employee, an S corporation is subject to employment taxes on reasonable compensation for services rendered.[7]

> S corporation must "match" and pay over to the IRS an amount equal to the FICA portion of the tax withholding. Under current law, the employee is required to pay (and have withheld) 7.65% of his wages toward Social Security (6.2%) and Medicare (1.45%). This means S corporation must also pay over to the IRS, out of its own funds, 7.65% of the employee's wages.

FRINGE BENEFITS

When it comes to tax deductions for qualifying fringe benefits, S corporations are treated like a C corporation ***and*** a partnership.

But first, what's a fringe benefit? According to the IRS, it is a "form of pay for the performance of services," such as when an employee is given a business car to commute to and from work.

Shareholder-employees in an S corporation owning ***2 percent or less*** of that entity, receives C corporation tax treatment. Fringe benefits that are taxable to these types of shareholder-employees include:

- Employer-provided health insurance (§106)
- Group-term life insurance (§79)
- Meals and lodging provided for the convenience of the employer (§119)
- Benefits provided under a cafeteria plan (§125)

Benefits that are nontaxable to shareholder-employees (as well as partners in a partnership) with ***more than 2 percent*** ownership include:

- Employee achievement awards (§74)
- Qualified group legal service plans (§120)
- Educational assistance programs (§127)
- Dependent care assistance programs (§129)
- No-additional-cost services and qualified employee discounts (§132)
- Medical savings accounts (§220)

C corporations hold several advantages when it comes to qualified benefits plans. For example:

- Corporate owners can receive tax-free term life (within limits) and medical benefits.
- Plan contributions may create a net operating loss for the business.
- Owners may borrow from the retirement plan.

Generally, C corporations provide greater flexibility in terms of deferred compensation benefits and stock option plans. S corporations cannot offer deferred compensation, but they can offer stock options, provided they do not create a second class of stock.

PARTNERSHIP LIMITATION

In most situations involving fringe benefits, a partner's status as self-employed is a drawback as these types of benefits generally receive favorable tax treatment only if the recipient is an employee.

> There is one major benefit for partners considered self-employed taxpayers: ***the ability to fully deduct the cost of health insurance***.[8]

§1372 provides that for fringe benefit purposes, the S corporation is treated as a partnership and any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership. A "2-percent shareholder" means any person who owns on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of such corporation or stock possessing more than 2 percent of the total combined voting power of all stock of such corporation.

MANAGING DEBT

Today's economic climate has no doubt dealt many of your clients a loss. It's bad enough, especially for small business owners, to have to wonder when they might return to profitability. Beyond that, tax recognition of their losses is limited.

But first, some definitions:

- Stock basis is roughly the investments made by the shareholder, plus cumulative net income, less cumulative net losses, less distributions made.
- Debt basis is roughly the debt loaned by the shareholder, less any losses deducted against the debt basis.

S CORPORATION DEBT AND MITIGATING BASIS

> S corporation shareholders may not deduct losses in excess of their basis in stock and debt. BUT THERE IS A SILVER LINING. Losses that are not deductible because of the tax basis limitation are not necessarily lost. Those losses are simply suspended until the shareholder produces additional basis. It is important to keep in mind that the suspended loss will disappear unused if the shareholder sells the stock before creating additional basis.

Question 3-1: At the beginning of the current year, Mr. Sam, 1/3 owner of Yosemite, had a basis in his Yosemite stock of $12,000. During the year, Yosemite reported a $75,000 ordinary business loss and no separately stated items. How much of the ordinary loss is allocated to Mr. Sam?

Answer: Loss allocation is $25,000 ($75,000 × 1/3).

Question 3-2: How much of the $25,000 loss clears the tax basis hurdle for deductibility?

Answer: The amount of Mr. Sam's basis in his Yosemite stock is **$12,000**. The remaining **$13,000** of loss does not clear the tax basis hurdle. It is suspended until Mr. Sam can generate additional basis.

Making a Loan: Possible Solution

The disadvantage of not including S corporation debt in a shareholder's stock basis can be mitigated by loaning money directly to the S corporation.

What Does this Do? These loans will create debt basis separate from the stock basis. These loans must be direct loans to the corporation pursuant to **IRC §1366(d)**. A simple loan guarantee to an S corporation will not provide shareholders with debt basis.

- If losses are incurred, those losses will be limited first to the shareholder's tax basis in their shares, and then to their basis in any direct loans made to the S corporation.
- Debt basis is similar to stock basis in that it cannot decrease below zero. Any net increase in basis for the year, or in subsequent years, will first restore the shareholder's debt basis (up to the outstanding debt amount), and then the shareholder's stock basis.
- Loan repayments in excess of the shareholder's debt basis will generate a taxable gain to the shareholder if the S corporation repays the debt owed before the shareholder's debt basis is restored.

PARTNERSHIP LOSSES

The basis in a partnership is a great deal more dynamic by comparison.

It must be modified as the partnership **(1)** creates income and losses, **(2)** experiences a change in debt levels, **(3)** and provides distributions to partners.

Changes in the partnership's debt affect the outside basis of partners. Pursuant to **IRC §752(a)**, if partnership debt increases, partners are treated as though they contributed cash to the partnership to the extent of their share of the increase in partnership debt. Therefore, if contributions of cash increase a partner's outside basis, then the increase in the partner's share of partnership debt will also increase that partner's outside basis.

Question 3-3: Velma, Daphne, and Freddy are equal partners in Fearless Security. The company borrows $15,000 from the Blewit Small Loan Company. ***What is each partner's outside basis?***

Answer: If each partner shares equally in the $15,000 borrowing, each partner is treated as having contributed $5,000 to Fearless Security under **IRC §752(a)**. As a result, each partner's outside basis in the business will increase by $5,000 (§722).

Decreases in a partner's share of partnership debt are treated as cash distributions to that partner, according to **§752(b)**. The partner's outside basis is decreased by the decline in that partner's share of partnership debt, because, according to the IRC (**§733**), cash distributions decrease a partner's outside basis.

Question 3-4: The Fearless Security partnership pays $12,000 of its loan from Blewitt Small Loan Company. ***What is each partner's outside basis?***

Answer: IRC §752(b) states that each partner is to be treated as receiving a distribution of $4,000. Therefore, each partner's outside basis has been decreased by $4,000 (§733).

> Generally, partners share recourse debt in proportion to how they share partnership losses. In regards to nonrecourse debt, it is generally shared among partners in proportion to how partnership profits are shared.

LOSS CLASSIFICATION

What happens when an owner of a limited liability company (LLC) that generates tax losses is not active in the business? The IRS could classify the losses as passive, subject to the passive activity loss (PAL) rules. In some cases, this can prevent the owner from deducting losses in the year incurred.

In general, losses from a business activity that is passive may be used only to offset income from other passive activities. Any excess passive losses are suspended and carried forward to future years. The taxpayer may deduct them in future years against passive income, if applicable. The taxpayer can eventually claim a suspended loss when selling or disposing of the activity that generated the loss.

> A taxpayer may not have passive income for years at a time, so their passive losses can remain suspended for years.

Fortunately, a business activity the taxpayer materially participates in is nonpassive and therefore exempt from the PAL rules. That means losses from the activity are deductible in the year incurred.

A trade or business is a passive activity if the taxpayer does not materially participate. The taxpayer materially participates if and only if he or she meets one of the following seven tests provided in **Reg. § 1.469-5T(a)**:

1. The taxpayer works 500 hours or more during the year in the activity.
2. The taxpayer does substantially all the work in the activity.
3. The taxpayer works more than 100 hours in the activity during the year and no one else works more than the taxpayer.
4. The activity is a significant participation activity (SPA), and the sum of SPAs in which the taxpayer works 100-500 hours exceeds 500 hours for the year.
5. The taxpayer materially participated in the activity in any 5 of the prior 10 years.
6. The activity is a personal service activity and the taxpayer materially participated in that activity in any 3 prior years.
7. Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year. However, this test only applies if the taxpayer works at least 100 hours in the activity, no one else works more hours than the taxpayer in the activity, and no one else receives compensation for managing the activity.

> **Note:** The first four tests look at a set number of hours of participation in the tax year. The next two tests look to material participation in prior tax years. The final test looks at the facts and circumstances but is highly restrictive.

WHAT IS THE IRS POSITION FOR LLC?

For years, the IRS has claimed that LLC owners must be treated as limited partners for purposes of the PAL rules since both limited partners and LLC owners have limited liability. The IRC **§469(h)(2)** presumes that limited partner interests are per se passive, and losses are therefore not deductible unless the taxpayer has passive income reported on the return.

There are three exceptions:

- The taxpayer works 500 hours or more in the trade or business activity.
- The taxpayer materially participated in the activity in any 5 of the prior 10 years.
- The activity is a personal service activity and the taxpayer materially participated in that activity in any 3 prior years.

If a taxpayer holds both a general and a limited partnership interest all year, he may use any one of the seven tests to qualify for material participation.

THOMPSON V. UNITED STATES

Facts

- Plaintiff (Thompson) formed Mountain Air Charter, LLC, an on-demand air charter business in Texas.
- Thompson held 99 percent of the member interests in the company directly, and 1 percent through a subchapter S corporation.
- Thompson claimed $2.1 million in losses from Mountain Air on his 2002 and 2003 individual income tax returns, and used the losses to offset against other income.

IRS

- Echoing its traditional stance, the IRS disallowed all but $156,000 of those losses, arguing they were passive activity losses and could not be used to offset non-passive activity income.
- Thompson paid the taxes assessed and then sought a refund.
- When the IRS denied, he brought suit, seeking a refund of $781,241 plus interest.

Lawsuit

- The main point of contention in the ***Thompson*** case was the interpretation of **IRC § 469**, which establishes limitations on passive activity losses.
- The section defines a "passive activity" as activity that involves the conduct of any trade or business, and in which the taxpayer does not materially participate.[9] In the case of limited partnerships (except as provided in regulations), ***no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates***.[10]
- Following IRC §469's passage, the IRS adopted Treas. Reg. § 1.469-5T, which defined how an investor could demonstrate material participation in an activity, while also greatly restricting the ways a limited partner could demonstrate material participation in a limited partnership. Specifically at issue in the ***Thompson*** case was Treas. § 1.469-5T (e) (3) (i):
    1. The IRS argued that the regulation applied to Thompson's LLC member interest because the company was taxed as a partnership for income tax purposes and because the liability of the members was limited under Texas law.
    2. The plaintiff contended that Mountain Air was not an LP, so his member interest could not be that of a limited partner.

Court Ruling

After reviewing, the Court concluded that an LLC was not "substantially equivalent" to a LP because unlike a LP, an LLC allows all members to participate while retaining limited liability.

Since LLCs are designed to permit active involvement by members, the Court felt it "makes little sense to extend the Code's presumption concerning limited partners' lack of participation in their partnerships to [the taxpayer] and his LLC."[11]

Since both parties stipulated that Thompson did not hold a LP interest, as defined under **Treas. § 1.469-5T(e)(3)(i)**, §469 would not limit Thompson's share of losses.

Therefore, as the taxpayer did not hold a limited partnership interest, §469 did not limit his share of Mountain Air's losses.

Moral of the Story

The ruling affirmed the need to proceed cautiously regarding the passive loss rules. LLC owners have not completely circumvented these rules. They must still prove that they materially participate in an LLC's activity if they intend to use losses and credits from that activity against active income.

But they can now use the more flexible rules of **Treas. Reg. § 1.469-5T(a)**; the ruling ended the treatment of losses that pass through to LLC owners as being ***per se*** passive by the IRS.

> (3) Limited partnership interest-(i) In general. Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if-
>
> > (A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or
> >
> > (B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

THE TAX EFFECTS OF DISTRIBUTIONS

TAX EFFECTS OF DISTRIBUTIONS ON S CORPORATIONS

S corporations are subject to special rules when accounting for distributions.

How are they different from wages? Shareholder distributions are treated differently than wages because they are deemed to be a return on the investor/employee's investment in the S corporation and not compensation for services rendered (see examples of calculations below).

How are they determined? Shareholder-level tax consequences of operating distributions are determined by the S corporation's history. ***Specifically, whether at the time of the distribution, the corporation had accumulated earnings and profits*** **(E&P)**.

Two scenarios are possible:

1. S corporation with NO C corporation accumulated E&P

> There are 2 possibilities: (A) Either the entity was an S corporation since inception or (B) it converted from a C corporation but did not have any accumulated E&P as a corporation at the time of the distribution.

Either way,

- If there was no C corporation accumulated E&P, then the rules for distribution are similar to those for partners, i.e. tax-free to the extent of the shareholders' stock basis.[12]
- If the distribution exceeded the shareholder's stock basis, the shareholder has a capital gain equal to the excess distribution amount.

2. S corporation with C corporation accumulated E&P

If there is accumulated E&P at the time of distribution, tax laws require that the corporation maintain an accumulated adjustments account (AAA) to determine the taxability of the distributions. The AAA represents the cumulative income or losses for the period the corporation was an S corporation. Even though the AAA may have a negative balance, the reduction for distributions may not cause the account to go negative or to become more negative.

S corporation distributions are paid in the following order:

- The AAA account
- Existing accumulated E&P for years the corporation operated as a C corporation
- Shareholder's stock basis

DISTRIBUTION AND RECOGNITION REQUIREMENTS

In general, corporate distributions to a shareholder should be treated as one of the following and for the following reasons:

- **Dividends** - If the distribution is from current or accumulated E&P.
- **Non-dividend distribution** - Any part of a distribution that is not from E&P is applied against and reduces the adjusted basis of the stock in the hands of the shareholder.
- **Gain** - To the extent the distribution is more than the adjusted basis of the stock, the shareholder has a gain (usually a capital gain) from the sale or exchange of property.

PROPERTY DISTRIBUTIONS

What Determines How the Property will be Distributed? There are two criteria: (1) the type of entities making and receiving a non-liquidating distribution, and (2) the type of property being distributed.

How's it Calculated? The amount of the distribution is generally the amount of any money paid to the shareholder plus the FMV of the property, reduced by any liabilities assumed. The basis of the property to the shareholder is the FMV of the property. In general, distributions are taxable as dividends to the extent of E&P.

A corporation will recognize a gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis.

This treatment is similar to a sale of property by the corporation. If the property was depreciable or amortizable, the corporation may have to treat all or part of the gain as ordinary income from depreciation recapture.

For this purpose, the FMV of the property is the greater of the following amounts:

- The actual FMV, or
- The amount of any liabilities a shareholder assumed connected to the distribution of property.

When S corporations distribute appreciated property to shareholders, they recognize gain as though they had sold the appreciated property for its fair market value (FMV) just prior to the distribution. Shareholders receiving distributed property recognize their distributive share of the deemed gain and increase their stock basis accordingly.

When are Property Distributions a Good Idea? Property dividends may make sense in a variety of circumstances, especially if the property can no longer be put to productive use by your business and only a small amount of taxable gain is at risk of being realized on the distribution. However, if the property's value is lower than its tax basis, a sale followed by a distribution of the cash proceeds may be the better way to go.

DISTRIBUTIONS OF STOCK OR STOCK RIGHTS

- Distributions by a corporation of its own stock are known as **stock dividends**.
- Stock rights (stock options) are distributions by a corporation of rights to acquire its stock.
- Distributions of stock dividends and stock rights are generally tax-free to shareholders.

Rule of Thumb

The distribution of stock or stock rights should be treated the same as other property if any of the following apply:

- Any shareholder has the choice to receive cash or other property instead of stock or stock rights.
- The distribution gives (1) cash or other property to some shareholders and (2) an increase in the % interest in the corporation's assets or E&P to other shareholders.
- The distribution is in ***convertible preferred stock*** and has the same result as the previous rule.
- The distribution gives preferred stock to some shareholders and common others.
- The distribution is on preferred stock.

DEEMED DISTRIBUTIONS

What is a "deemed distribution"? This is how the IRS put it: "A deemed distribution differs from other distributions in that the participant is taxed as if the distribution were received, but the treatment of the loan as a distribution does not excuse the participant from the obligation to repay the loan. A failure to repay the loan may result in additional tax consequences and, in some cases, a prohibited transaction."

Certain events may be treated as a distribution to a shareholder, including:

- **Below-market loans** - If a corporation gives a shareholder a loan on which no interest is charged, or on which interest is charged at a rate below the applicable federal rate, the interest not charged may be treated as a distribution to the shareholder.
- **Corporation cancels shareholder's debt** - If a corporation cancels a shareholder's debt without repayment by the shareholder, treat the amount canceled as a distribution.
- **Transfers of property to shareholders for less than FMV** - A sale or exchange of property by a corporation to a shareholder may be treated as a distribution to the shareholder. For a shareholder who is not a corporation, if the FMV of the property on the date of the sale or exchange exceeds the price paid by the shareholder, the excess may be treated as a distribution.
- **Unreasonable rents** - If a corporation rents property from a shareholder at above-market rates, the excessive part of the rent may be treated as a distribution to the shareholder.
- **Unreasonable salaries** - If a corporation pays an employee who is also a shareholder a salary that is unreasonably high considering the services actually performed by the shareholder-employee, the excessive part of the salary may be treated as a distribution.

LIQUIDATING DISTRIBUTIONS

Liquidating distributions are distributions received during a partial or complete liquidation of a corporation.

These distributions are, in part at least, one form of a return of capital. The corporation may pay them in one or more installments.

> A liquidating distribution is not taxable until the taxpayer recovers the basis of the stock.

Other Facts

- After the basis of the stock is reduced to $0, the liquidating distribution is a capital gain, either long-term or short-term depending on how long the taxpayer held the stock.
- If the total liquidating distributions are less than the basis of the stock, the shareholder has a capital loss, reportable only after receipt of the final distribution in liquidation that results in the redemption or cancellation of the stock.
- The disallowance of losses from the sale or exchange of property between related persons ***does not*** apply to liquidating distributions.

Corporate Tax Rules Apply

- Tax consequences associated with a complete liquidation of the S corporation are governed by the rules under **IRC §331** and **§336**.
- These gains and losses are apportioned to the S corporation shareholders, increasing or decreasing their stock basis.
- Generally, shareholders accept gain on the distribution if the value of the property surpasses their stock basis.
- Loss is recognized if their stock basis beats the value of the property.

POST-TERMINATION TRANSITION PERIOD DISTRIBUTIONS

Suspended losses at the S corporation termination date receive special treatment.

IRC §1371(e) deals with the special treatment of any S corporation cash distributions after an S election termination, and during the post-termination transition period (PTTP). Generally, the PTTP for post-termination distributions is the same as the PTTP for deducting suspended losses.

DIFFERENCE IN TAX TREATMENT OF WAGES & SHAREHOLDER DISTRIBUTIONS

Example 1 – All Wages and No Shareholder Distributions

- Capone, Inc. is an S corporation. It has one shareholder who also performs services for the company.
- During the current year, the S corporation pays $80,000 of wages to its sole shareholder and zero shareholder distributions.
- Here is the FICA calculation for the wages paid to the shareholder:
  1. Withheld from shareholder (employee): $6,120 ($80,000 wages × 7.65%)
  2. Employer matching (paid from S corp funds): $6,120
  3. Total FICA tax paid: $12,240 (employee and employer share)

The S corporation will issue a W-2 to its shareholder in the amount of $80,000 and the shareholder must report that as income from wages on his personal tax return.

Example 2 – 50% Wages and 50% Shareholder Distributions

- Same facts as Example 1 except that Capone, Inc. pays $40,000 of wages to its sole shareholder and $40,000 of shareholder distributions.
  1. Withheld from shareholder (employee): $3,060 ($40,000 wages × 7.65%)

2. Employer matching (paid from S corp funds): $3,060
3. Total FICA tax paid: $6,120 (employee and employer share)

The shareholder gets a W-2 for $40,000 and reports that as wages on his return. The $40,000 of shareholder distributions is a return of capital (tax-free to the extent of the shareholder's stock basis) and is not subject to self-employment tax.

TAX EFFECTS OF CASH DISTRIBUTIONS IN OPERATING PARTNERSHIPS

Partnership distributions are subject to some of the most difficult Code provisions ever written.

Be Warned. The relevant Code governing partnership distributions is both complex and ambiguous.

Three Complicating Factors:

1. ***Not all payments by a partnership to a partner are considered distributions.***
   a. For example, payments made to a retiring partner or a decedent's successor could be classified as guaranteed payments or distributive shares under §736.
2. ***IRC §751(b) often overrides the usual rules for taxing distributions.***
   a. This frustrating section of the Code treats some distributions as consisting of different, "constructive" distributions, including exchanges of distributed money or property between a partner and the partnership.
3. ***If a §754 election is in effect, distributions can trigger inside basis adjustments***.

TAX ON THE DISTRIBUTIVE SHARE

A partner must pay taxes on the distributive share of partnership income allotted to their interest in the partnership ***regardless of whether the income is distributed***.

Since a partner reports their share of income, regardless of distributions, the partner does ***not*** recognize income simply because a distribution takes place.

> A distribution is generally considered a tax-free return of capital to the partner, and neither the partner nor the partnership recognizes any gain or loss. A partner's adjusted basis in their partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner.

Question 4-1: The adjusted basis of Velma's partnership interest is $14,000. She receives a distribution of $8,000 in cash and land that has an adjusted basis of $2,000 and FMV of $3,000. ***What is Velma's gain on the distribution (if any)?***

Answer: Because the cash received does not exceed the basis of her partnership interest, Velma does not recognize any gain on the distribution. (She may recognize gain on the land when she sells or otherwise disposes of it.) The distribution decreases the adjusted basis of Velma's partnership interest to $4,000 [$14,000 – ($8,000 + $2,000)].

WHEN A PARTNER RECOGNIZES A GAIN

Typically, a partner recognizes gain on a partnership distribution when any money included in the distribution exceeds the adjusted basis of the partner's interest in the partnership.

Any discharge of partnership liabilities should be treated as a distribution of money to the partner. Generally, a marketable security distributed to a partner is treated as money in determining whether the partner will recognize a gain on the distribution.

This treatment, however, does not generally apply, if that partner contributed the security to the partnership, or an investment partnership made the distribution to an eligible partner.

Other Characteristics

- Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution.
- Distributions that alter a partner's share of unrealized receivables or substantially appreciated inventory may be taxed as ordinary income (instead of a capital gain).
- If the partnership distributes property to a partner, the partner generally does not recognize any gain until the sale or other disposition of the property.

Question 4-2: The adjusted basis of Shaggy's partnership interest is $10,000. He receives a distribution of $12,000 cash. What gain (if any) will Shaggy realize on the distribution?

Answer: Because the money received exceeds the basis of his partnership interest, Shaggy will recognize a gain on the distribution. The distribution decreases the adjusted basis of Shaggy's partnership interest to $0 ($10,000 – $12,000), as it cannot be less than zero. The remaining $2,000 is a capital gain.

PARTNER'S BASIS FOR DISTRIBUTED PROPERTY

The basis of property distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership, reduced by any money received in the same transaction. A partner's holding period for property distributed to the partner includes the period the partnership held the property. If a partner contributed the property to the partnership, then the period that partner held the property is also included.

Question 4-3: The adjusted basis of Huey's partnership interest is $10,000. He receives a distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. ***What is his basis?***

Answer: His basis for the distributed property is limited to $6,000 ($10,000 – $4,000, the cash he receives).

Question 4-4: The adjusted basis of Dewey's partnership interest is $6,000. He receives a distribution of $7,000 cash and a laptop computer that has an adjusted basis of $2,000 and FMV of $4,000. ***What is his basis?***

Answer: Because the cash received exceeds the basis of his partnership interest, Dewey will recognize a capital gain on the excess money received of $1,000 ($7,000 – $6,000). The distribution decreases the adjusted basis of Dewey's partnership interest to $0 [$6,000 – ($7,000 + $2,000)], as it cannot be less than zero. Since Dewey's does not have a basis in his partnership interest, the basis of the laptop is $0. He will recognize any gain on the laptop when he sells or otherwise disposes of it.

LIQUIDATING DISTRIBUTIONS

A partner does ***not*** recognize a loss on a distribution unless ***all*** the following requirements are met:

- The adjusted basis of the partner's interest in the partnership ***exceeds*** the distribution.
- The partner's entire interest in the partnership is liquidated.
- The distribution is in money, unrealized receivables, or inventory items. ***No loss is recognized if any other property is received***.

The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction. If the basis of property received is more than the basis of the partner's interest in the partnership (reduced by money received), it must be divided among the properties distributed to the partner.

How to Allocate the Basis?

Follow these rules:

- Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution. **Note:** If the total of these assigned bases exceeds the allocable basis, ***decrease the assigned bases by the amount of the excess***.
- Allocate any remaining basis to properties other than unrealized receivables and inventory items by assigning a basis to each property equal to the partnership's adjusted basis in the property. **Notes**: (1) If the allocable basis exceeds the total of these assigned bases, ***increase the assigned bases by the amount of the excess***. (2) If the total of these assigned bases exceeds the allocable basis, ***decrease the assigned bases by the amount of the excess***.

Question 4-5: Louie's basis in his partnership interest is $55,000. In a distribution in liquidation of his entire interest, he receives properties A and B, neither of which is inventory or unrealized receivables. Property A has an adjusted basis to the partnership of $5,000 and a fair market value of $40,000. Property B has an adjusted basis to the partnership of $10,000 and a fair market value of $10,000. ***What is Louie's basis in each property?***

Answer: To figure his basis in each property, Louie first assigns bases of $5,000 to property A and $10,000 to property B (their adjusted bases to the partnership). This leaves a $40,000 basis increase ($55,000 allocable basis minus $15,000 total of the assigned bases). He first allocates $35,000 to property A (its unrealized appreciation). He allocates the remaining $5,000 between the properties based on their fair market values: $4,000 ($40,000 ÷ $50,000) to property A and $1,000 ($10,000 ÷ $50,000) to property B. Louie's basis in property A is $44,000 ($5,000 + $35,000 + $4,000) and his basis in property B is $11,000 ($10,000 + $1,000).

CHANGES IN BUSINESS

CONVERSIONS

Changing business forms is par for the course for most businesses, particularly start-ups. Changes in the marketplace, emerging technologies, unforeseen internal developments, and problems often dictate that a business operate as a different entity. Before advising such a leap, however, the situation must be carefully analyzed to determine the feasibility of such a change and any corresponding tax consequences.

Converting from one business entity to another typically follows one of four standard approaches:

1. Assets up approach
    a. Old entity makes a liquidating distribution of its assets and liabilities down to its owners
    b. Owners then contribute the assets and liabilities up to a new entity in exchange for ownership interests
2. Interests over approach
    a. Owner exchanges interest in old entity for interest in new entity
    b. Old entity then dissolves and assets and liabilities become assets and liabilities of the new entity
3. Assets over approach
    a. Old entity transfers its assets and liabilities over to a new entity in exchange for ownership interest in the new entity
    b. Old entity then makes liquidating distributions of those interests to the owners
4. Statutory conversion
    a. Old entity transforms into a new entity by filing a document with the relevant state authority

SALES

SOLE PROPRIETORSHIPS

The assets of a sole proprietorship (which are transferred during a sale) must be analyzed separately for tax consequences.

Gain or loss is determined by subtracting the owner's tax basis from the sale price of the asset. If a gain is realized, then a depreciation recapture is required. This is only the case if the depreciation deductions for the assets were not taken in the years of ownership prior to the sale.

> **IRC §1231** assets may or may not qualify for favorable capital tax rate treatment when sold. If a §1231 asset is sold at a gain, the gain is taxed as original income to the degree that it corresponds to the recapture of depreciation deductions taken in a previous period. A more favorable capital gains rate applies for any gain over the depreciation recapture.

PARTNERSHIPS

A partner selling a partnership interest must be aware of the following factors:

1. **Seller's Amount Realized**
   a. A partner's outside basis will depend, in part, on the partner's share of the partnership's liabilities.
   b. **IRC §752(d)** states "partnership liabilities shall be treated in the same manner as liabilities in connection with the sale...of property not associated with partnership" whenever a partnership interest is sold
2. **IRC §751(a)**
   a. Many partnerships have §751 property (unrealized receivables and inventory items);
   b. If it does, the seller needs to calculate gain and loss separately on (a) the sale of the interest attributable to that kind of property and (b) the sale of the balance of the interest
3. **Taxation of Look-through Gains Under Section 1(h)**
   a. Section 1(h) states that some kinds of capital gains are subject to a higher maximum tax rate than the usual 20 percent maximum rate on long-term capital gains.
   b. A gain on a collectible, for example, can be taxed up to a maximum rate of ***28 percent***
   c. Section 1(h)(5)(b) requires gain from the sale of a partnership interest, that "which is attributable to unrealized appreciation in the value of collectibles," to be treated as collectibles gain to the selling partner

COLLATERAL EFFECTS OF A SALE

While the sale of a partner's interest in a partnership closes the partnership's taxable year for the seller, ***it does not necessarily do the same for other partners.***

Sellers selling only a portion of a partnership interest will not close the partnership's taxable year and some factors such as the handling of distributive shares must be addressed.[13]

Termination under **§708(b)(1)**:

- Some sales of partnership interests will cause the partnership to terminate under Section **708(b)**.
- A partnership must terminate if "within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits." Therefore, ***if the partner sells a 60-percent interest***, the partnership terminates.
- The partnership also terminates, if the partner decides to sell only 30-percent one year, but another partner decides to sell their 30-percent interest with a year of the first sale.

- A partnership terminating under **§708(b)(1)** is treated as if it contributed all of its assets and liabilities to a new partnership.
- The old partnership is considered to be liquated, and distributes its only asset (a 100-percent interest in the new partnership) to members of the old partnership who held on to their interests, as well as to those who caused the partnership to terminate.
- As transfers of property to partnerships are generally tax-free, this event will seldom have severe tax consequences for the remaining partners.

LIMITED LIABILITY COMPANIES

Members seeking to transfer or dispose of their interests must first look to the transfer or sale restrictions language contained in the Operating Agreement.

What to Watch Out for When Selling It All...

When a sale of substantially all of the LLCs assets occurs:

- Gain or loss realized is passed through and taxed to the members
- Gain increases the basis of the members' interests so that a distribution of sale proceeds will not be subject to a second level of tax[14]
- Gain for the sale is generally eligible for the installment method, ***with the exception of gain attributed to unrealized receivables and inventory***, which must be reported immediately

CORPORATIONS

C Corporations:

A C corporation selling substantially all of its assets will have to recognize gain or loss on the sale (unless the sale is pursuant to a tax-free reorganization).

> Unless a shareholder owns at least ***80 percent*** of the voting power and value of the liquidating corporation, the shareholder will have to also recognize gain or loss on the liquidating distribution. Generally, the installment method can be used with respect to the gains from a sale, except for the gain from the sale of inventory and recaptured income, which must be reported immediately.

S Corporations:

This differs for an S corporation where the gain or loss realized from a sale will be passed through and taxed to the shareholders.

CREATING A WIN-WIN SITUATION

Decisions, Decisions, Decisions

During the sale of a corporation, a decision must be made around whether the deal will be a stock or asset purchase.

Impact on Buyer vs Seller

For the seller, a stock sale is beneficial while the buyer will likely prefer an asset purchase.

The question then becomes is there a way you can reconcile the two preferences to create a winning situation for both parties. The answer is "yes" because of **IRC §338**.

IRC §338 is Key

This section of the Code allows the seller to sell stock and enjoy the favorable tax advantages of doing so, while also allowing the buyer to receive the desired step-up basis of the purchased assets (as well subsequent depreciation expenses in the years to follow).

At first glance, this election looks to be a hard sell to the buyer. After all, she would be responsible for any tax arising from the step-up in basis of the acquired assets, and as the transaction would be effected with stock, the buyer would assume the liabilities (known and unknown) of the company.

So why agree to this then? Because of certain tax characteristics associated with the entities involved in the sale that may well enable the buyer to avoid paying any tax bill "out of pocket."

> Consider this hypothetical: If the corporation up for sale has net operating loss carry-forwards and tax credit carry-forwards, these tax attributes could be used to offset tax liability created under the §338 election. Thus, the buyer would receive a step-up in basis without owing tax.

More on IRC §338

An IRC §338 may be viable if the corporation being sold has:

- Unused operating losses, capital losses, or tax credit carry-overs.
- Assets with a market value that is less than the book value, and the corporation has owed and paid income taxes in the last few years.[15]
- Non-depreciable built-in loss property and depreciated built-in gain property. **Note**: These gains and losses have the effect of canceling one another out following the sale. Furthermore, the depreciated property will have a stepped-up basis that will provide a larger depreciated deduction moving forward.
- Stockholders that will recognize minimal gains or losses on the sale of the company's stock.

To utilize IRC §338,

- Company being sold must be a U.S. corporation, and being purchased by a C corporation.
- The election cannot be taken in a non-taxable stock deal.
- An individual, partnership, or LLC taxed as a partnership trust, cannot be the purchaser. **Note**: However, individuals and partnerships may be able to skirt this requirement by forming a new corporation to purchase the company for sale.
- A §338 election must be made by the fifteenth day of the ninth month after the month in which 80 percent control of the company targeted is acquired (within 8.5 months).

> The rules of an IRC §338 election are complicated. They are filled with specific conditions and provisions, many of which require a thorough vetting before determining if the advantages outweigh the potential disadvantages and drawbacks for all parties involved in the sale. This section is merely meant to provide you with a brief overview of just one possible way in which to structure the sale of a corporation.

REORGANIZATIONS

> Tax-free reorganization provisions in the Code ***only apply to corporations***. They do not apply to LLCs, LPs, and GPs. Therefore, the discussion below is limited to S and C corporations and the current tax-free reorganization provisions.

Reorganization Can be a Good Thing

From time to time, taxpayers may find it necessary to reorganize their corporate structure. Fortunately, the Code does provide for tax deferral to the corporation involved in the reorganization and the shareholders provided the transaction meets:

- One of the seven statutory definitions outlined in **Section 368(a)(1)**
- Satisfies the judicial principles outlined in the reorganization statutes

That's the Good News. Of course, there's always a caveat. You're likely to find little guidance in the way of statutory language governing how corporate reorganizations are taxed. It's often a matter of interpretation of the IRS and courts. Both, unfortunately, haven't exactly provided the clearest set of rulings on the issue.

What Can We Tell You?

There are several types of tax-deferred corporation reorganizations. This means there are also multiple ways to structure the transaction and potentially achieve tax deferral for the parties involved. Table 5-1 provides an overview.

Table 5-1: Overview of Tax-Deferred Corporation Reorganizations

Form of Reorganization	Description
Type A	Type A reorganizations are statutory mergers or consolidations. ABC Corp acquires the assets and liabilities of XYZ Corp in return for stock or a combination of cash and stock. The acquisition qualifies as tax-deferred, if the transaction satisfies the continuity of interest and business, and business purpose requirements. Variations of Type A include Forward Triangular and Reverse Triangular reorganizations.
Type B	ABC Corp acquires XYZ Corp by using its voting stock (or the voting stock of its parent corporation) to gain control (80% voting power and 80% nonvoting stock). To qualify for tax-deferred status, XYZ Corp shareholders must receive ***solely*** voting stock of ABC Corp.
Type C	ABC Corp acquires XYZ Corp by using its voting stock (or voting stock of its parent corporation) to gain "substantially all" of XYZ Corp's assets. While similar to a Type A reorganization, a Type C reorganization differs in that the IRC governs the form of the transaction instead of state law as with a Type A.
Type D	XYZ Corp transfers all or part of its assets to ABC Corp. Immediately following the transfer, the shareholders of ABC Corp own at least 50% of the voting power or value of XYZ Corp (non-divisive Type D). If after the transfer, shareholders owned 80% of XYZ Corp, then it is a divisive Type D.
Type E	Also referred to as recapitalizations. Generally, under these arrangements, stock in the corporation is exchanged for a different class of stock or securities, i.e. common stocks traded for preferred or debt.
Type F	This type of reorganization is used to change a corporate name or a state (country) of incorporation. In other words, it is used to simply affect a change in identity, form, or place of organization for a single corporation.
Type G	Also known as bankruptcy reorganizations. Under a Type G, a corporation would transfer all or part of its assets to another corporation in a Title 11 case. The stock of the corporation receiving the assets is distributed in a transaction that is tax-deferred.

Going S

One of the advantages of electing S corporation status is the ability of the entity, and its shareholders, to use these tax-free entity reorganization rules. Under these rules, shareholders are allowed to exchange stock in their corporation for the stock in a corporation that is a party to the reorganization. That exchange will generally be tax-free.

LLCs and LPs Not So Lucky

These rules do not exist for LLCs or LPs. If such reorganization were to occur, it would likely trigger a termination if more than 50 percent of the ownership changed within a year. It may also create a taxable event, depending on the circumstances.

CONVERSIONS

Partnerships and LLCs

Given the similarities between the structure of a partnership and an LLC, a conversion of one into another tends to have fairly minimal tax consequences. ***The conversion will be treated as a tax-free transaction, as long as the amount of liabilities of the partnership does not exceed the amount of its assets.***

If a corporation elects to be converted into an LLC, the conversion is treated as if the corporation liquidated itself and contributed its assets to the new LLC. The corporation will realize a gain (the difference between the FMV of the corporation over its assets).

Other Features and Considerations

- Individual shareholders will also realize a gain based on the FMV of their shareholdings over and above the value of the corporation's assets.
- Gain will pass through to shareholders in an S corporation conversion to an LLC, but in some situations, the S corporation may also incur a built-in gain when liquidated.
- Depending on the nature of the assets transferred, this realized gain may be categorized as either capital or ordinary income. ***The membership interests each shareholder receives in the new LLC will be valued at the combined amount of their original shareholding plus any applicable gains***.

LIQUIDATION

There are situations in which taxable corporations may find it beneficial to mitigate the double tax they sometimes encounter.

> Again, taxable corporations can elect to make an S corporation election if eligible to do so. Unfortunately, this may not be an option for many corporations **because of tax rule restrictions prohibiting certain corporations from operating as S corporations.** Thus, the only other options may be for shareholders to liquidate the corporation and form the business as a partnership or LLC.

What Happens? Generally, if a C or S corporation liquidates and distributes assets to shareholders, ***the corporation realizes gain or loss on each asset as if it had sold each asset at FMV***. The shareholder also recognizes the gain or loss on the liquidation to the degree that the value of property they received differs from their stock basis.[16] For a taxable corporation, this means that the corporate gains from liquidating are subject to double taxation, and corporate losses from liquidating receive a double benefit. Because the corporate level gains or losses flow through to the owners, S corporations do not receive double taxation or double benefits.

The liquidation of an entity taxed as a partnership usually does not trigger gain or loss at the entity level or partner level. A partner may, however, in certain situations, recognize a loss on a liquidating distribution.

ESTATE PLANNING ISSUES

SUCCESSION PLANNING

Ben Franklin was pretty much on the mark when he said, "The only things certain in life are death and taxes." While death is inevitable, paying taxes may not be. That's when planning can help! Proper estate planning can significantly influence the amount of transfer and estate taxes owed. Without proper planning, the cost of transferring wealth from one generation to the next could be substantial.

For business owners and shareholders, ***business succession planning*** is both a necessary and important component of estate planning. Historically, business entities have also been formed to accomplish specific estate-planning objectives, such as asset management, asset preservation and estate reduction.

TRANSFER TAXES & WEALTH PLANNING

A Powerful Combination

Wealth planning can effectively combine income and transfer tax strategies with non-tax succession objectives. If handled in the right way, wealth planning can ***maximize after-tax wealth transferred from one generation to the next***.

Sounds straightforward enough, right? Well, as you would expect, it's not. While there are several effective tax strategies that can be employed, they are often constrained by the client's specific non-tax goal.

This is where you come in?

The goal is to identify the right combination of tax strategies that also help clients to achieve their specific non-tax objectives.

STEP-UP IN TAX BASIS

The old adage that "timing is everything" is especially relevant when it comes to tax planning.

Reducing the present value of tax paid by delaying the payment of that tax is generally a good tax strategy. However, deferral is just one, albeit important, aspect of transfer tax planning. Sufficiently planning for the potential appreciation of assets transferred, and the potential effect any income tax will have when the appreciation is realized, is another necessary component.

Gifted Property vs Inherited Property

> Gifted property generally preserves the donor's basis in the property (donee gets a carryover basis), while inherited property gets a tax basis of fair market value.[17]

There are several important factors to consider when making a decision whether or not a lifetime transfer (gift) is more effective from a tax perspective.

A lifetime gift is often more advantageous when capital gain property is expected to appreciate substantially. A transfer tax applies to the fair market value of property on the date of the gift, but it does not apply to post-gift appreciation. Because the value of the property leaves the donor's estate, any appreciation is not subject to the estate tax. This can result in substantial savings. When the property is sold, the recipient of the gift may be liable for capital gains tax on any resulting gains from the sale of capital gain property using the donor's adjusted basis as cost. If the combined gift and capital gains tax results in less tax than the anticipated estate tax, taking into consideration the time value of taxes paid, it may make financial sense to gift the property to a beneficiary or in trust.

A testamentary transfer (at death) is often more favorable when property is already substantially appreciated. This is due to the step-up in tax basis received at the time of death, which allows the transfer to avoid capital gains tax. For inherited property, past appreciation (up to the date of death) is usually not subject to income tax, but it is subject to transfer tax at the time of transfer. The fair market value of inherited property is part of the gross estate. Under current rules, the maximum tax rate applicable to transfers by gift or inheritance is 40%.

> The step-up in tax basis becomes critical if a sale is planned in order to avoid being taxed on the accumulated appreciation. In this example, a testamentary transfer would provide a step-up in tax basis and delay payment of the transfer tax for three years.

Timing is Everything

Again, timing is critical when it comes to determining how to trade off income tax savings against transfer tax costs. The adjustment to basis can be step-up or step-down, and a sale can help in thwarting the elimination of the loss deduction. That is why tax advisors often recommend to their senior clients to sell business assets or investments with unrealized losses because upon death the basis of those assets is adjusted downward to FMV.

BYPASS PROVISION

It is natural for many individuals to be concerned about ensuring that they have sufficient wealth available to support themselves while still living. For couples, ensuring that the surviving spouse has adequate income to live on once one spouse has died motivates them to often set up their wills where one spouse leaves all of his or her property to the surviving spouse. While this does avoid the problem of estate taxes on the estate of the first spouse who dies (assuming the estate contains no terminable interest), it does not necessarily minimize total transfer taxes when the estates of both spouses are considered together.[19]

Bypass Provisions an Option

Including a bypass provision in the will of the deceased spouse can allow the unified credit to be used to transfer some of the property to beneficiaries other than the surviving spouse, thus ***reducing total estate taxes and the savings*** (which can prove significant).

> The bypass provision must be ***explicitly*** stated in the will. If not, any property transferred to bypass the spouse will not be available to support the surviving spouse. Therefore, a married couple should consider the provision only after estimating the amount of support that will be needed for the surviving spouse. If enacted, a separate trust is created known as a ***Credit Shelter (or Bypass) Trust***. This trust provides the surviving spouse with income for their remaining life, and upon death the principal transfers to its beneficiaries. This strategy allows each spouse to claim an exclusion, thereby increasing the amount of assets that transfer to beneficiaries free of estate tax.

A relatively new benefit exists (made permanent in 2012) that essentially accomplishes the same thing as a Bypass Trust without the need of establishing trusts. An executor filing an estate tax return can elect to transfer any deceased spousal unused exclusion (DSUE) amount to a surviving spouse, regardless of the size of the gross estate or amount of adjusted taxable gifts. The election to transfer a DSUE amount to a surviving spouse is known as the ***portability election***. This is a planning opportunity for married couples.

In order to elect portability of the decedent's unused exclusion amount (deceased spousal unused exclusion (DSUE) amount) for the benefit of the surviving spouse, the estate's representative must file an estate tax return (Form 706) and the return must be filed timely. The due date of the estate tax return is nine months after the decedent's date of death, however, the estate's representative may request an extension of time to file the return for up to six months.

SERIAL GIFTS

Serial gift strategies are another popular transfer tax planning technique because it's an easy and low-cost planning strategy.

But what is a Serial Gift? And What Does It Do Specifically? Essentially, serial gifts are used to change large taxable transfers into tax-exempt transfers by separating the transfer into multiple inter vivos gifts. They are exempt from all transfer taxes provided the gifts qualify as present interests and do not exceed the annual exclusion.

> In 2021, individuals can transfer up to $15,000 each year tax-free to any specific donee. If married, both spouses can separately give gifts valued at up to $15,000 to the same person in 2021 without making a taxable gift.

Family Businesses

Gifts of family business interests are generally attractive because the value of such interests for gift-tax purposes is less than the pro-rata value. For instance, a 10 percent business interest has a FMV of less than 10 percent of the business' assets because of certain valuation "discounts" that apply. This includes a discount for lack of voting control and a discount for lack of marketability. The section entitled "Family Issues" provides additional insights into this topic.

Generally, the IRS considers any gift taxable; however, there are exceptions as outlined in IRS Publication 950 Introduction to Estate and Gift Taxes. Non-taxable gifts include:

- Gifts, excluding gifts of future interests, that are not more than the annual exclusion for the calendar year,
- Tuition or medical expenses you pay directly to a medical or educational institution for someone,
- Gifts to your spouse,
- Gifts to a political organization for its use, and
- Gifts to charities.

Question 6-1: Fred and Wilma decide to begin transferring wealth to Barney and Betty. They want to do so using the serial gift technique. ***How much can they transfer without triggering gift taxes?***

Answer: Fred and Wilma could make annual gifts of $15,000 each to Barney and Betty.

These gifts would remove $60,000 per year from the estate without triggering any transfer taxes. They could also include any type of property, provided Barney and Betty could enjoy the property or income generated by it now.

INSTALLMENT SALES

In situations ***where individuals are holding assets that may greatly appreciate in value***, an installment sale may prove helpful in reducing estate taxes.

According to the IRS, an installment sale is "a sale of property at a gain where at least one payment is to be received after the tax year in which the sale occurs." These sales are reported on **IRS Form 6252**.

How Does It Work?

If the purchase price for an asset has been given "full and adequate consideration," and the sale properly documented in such a way as to create a legally enforceable obligation, the sale of an asset on an installment basis to a family member can be effective in shifting the potential appreciation of that asset to the family member. When the payee dies, the unpaid balance of the note is included in his or her taxable estate for estate tax purposes, but the asset that was sold, along with its appreciated value, will no longer remain in the estate.

Installment sales can offer a useful tool for many taxpayers to create liquidity to buy and sell property in an otherwise "credit-sparse" environment.

TRUSTS

A common non-tax objective in wealth planning is to preserve value during the transfer of control of business assets. Trusts are an attractive tax-planning vehicle in this respect because they can be structured to achieve a wide variety of tax and non-tax objectives. There are a variety of trust options available for perfecting wealth transfer, which range from the simple to the more complex. The effectiveness of each will depend largely on a client's individual circumstances.

BY-PASS TRUSTS

Bypass trusts are often ***used to decrease high taxes faced by non-spousal heirs***. Also known as a Credit Shelter Trust, these trusts are created to shelter property from federal estate taxation by taking advantage of the unified tax credit. Property placed in the trust is not subject to federal estate tax in the surviving spouse's estate, as it "by-passes" the surviving spouse's estate. A by-pass trust is also structured in a way that the estate escapes taxation upon the subsequent death of the second spouse, passing the remainder of the estate free of tax to the children.

> A key to bypass trusts is proper drafting to ensure, for example, that the surviving spouse does not have too much control over the trust's assets. If the spouse has too much control, these assets could be included in her taxable estate instead of bypassing it. The extra funds may increase the spouse's estate over the federal estate tax exemption amount and require estate taxes to be paid at his or her death.

LIFE INSURANCE TRUSTS

A type of irrevocable trust, the life insurance trust is created to ***hold life insurance on the life of the grantor or another person***. The primary purpose of this type of trust is to exclude the life insurance proceeds payable on the death of the grantor from federal estate taxation.

How It Works

The amount of the insurance policy is paid into the trust, when the grantor dies, but is not included in the grantor's estate. More importantly, an immediate cash distribution from the trust is not taxable income to the beneficiaries.

Things that cannot be done

- Beneficiaries cannot be changed. So, if the family situation changes, like a couple gets divorced or wants to disown a dead-beat son, clients are stuck with their decision.
- Life insurance policies, in general, can be borrowed against. Not so for those set up as trust funds.
- An existing life insurance policy cannot be transferred to a trust fund. Well, not if the aim is avoid estate taxes.

GRANTOR RETAINED INTEREST TRUSTS (GRITS)

Another commonly used trust instrument used that saves on transfer taxes is the Grantor Retain Interest Trusts (GRITS).

3 Main types

- Qualified Personal Residence Trust ("QPRT")
- Grantor Retained Annuity Trust ("GRAT")
- Grantor Retained Income Trust ("GRIT")

Closer Look at the GRIT

Simply put, GRIT allows a homeowner to transfer ownership of a residence during his or her lifetime to reduce the estate taxes heirs would have to pay if the residence were held until death. GRITs are helpful in reducing the tax of those who expect their estate to exceed the amount sheltered from estate tax by the unified estate gift tax credit.

What Else You Need to Know

- The longer the retained-interest period, the lower the value of the remainder interest is. If the grantor of a retained-trust outlives their benefits under the trust, the trust's assets are excluded, and the only transfer-tax cost due is the gift tax paid on the original value of the remainder trust.
- However, if the grantor passes away before the benefits are terminated under the trust's terms, the assets are subject to estate taxes in the grantor's estate (any gift tax paid is also credited toward the estate tax).
- The one significant disadvantage of GRITs is the loss of the stepped-up basis for income tax purposes. Assets in a successful retrained-interest trust are not included in the grantor's estate at the time of death; therefore, there is no stepped-up income tax basis. The recipient bears the grantor's original cost basis.

A FAMILY AFFAIR

Around 84% of family-owned businesses anticipate passing control of that business to the next generation. Unfortunately, many are unprepared for this transition. Succession planning is of paramount importance to the continuation of a family-owned business. The keys here are for your clients to TALK early and often (about elements of the succession plan, like when does the older owner want to retire), WRITE (put the plan for stock transfer and management succession in a formal document, HIRE (someone to handle this) and ASK (what plan is best).

When advising clients on the best strategies, here are the major ones:

- **Gifting**
  1. Takes advantage of IRS rules that say individuals can pass $11.7 million (2021 ***applicable exclusion***) in tax-free gifts, plus $15,000 a year to each recipient (2021 ***annual gift tax exclusion***)
- **Family limited partnership**
  1. Allows owners to transfer up to **99 percent** of their business to their children while retaining control
  2. The vehicle Sam Walton used to move big chunks of Wal-Mart (NYSE:WMT) to his heirs while still holding the operational reins of the company
- **Self-canceling installment note**
  1. Series of installment payments over a predetermined period, with fair-market interest added, set up for the younger generation to pay to the older one
  2. Obligation is terminated upon the death of the seller, which makes this particularly suited for older sellers
- **Private annuities**
  1. Work similarly to self-canceling installment notes, except the payments usually continue throughout the seller's lifetime rather than for a specific amount of time
  2. Interest payments with these aren't tax-deductible, though, as they are for a SCIN
- **Buy-sell agreements**
  1. Dictate how co-owners deal with the shares of an equity holder who leaves the company (through death or otherwise)
  2. In some cases, they involve co-owners all holding life insurance policies on one another and using the insurance settlement to pay for a buyout
- **Grantor-retained annuity trust**
  1. One of several vehicles that let the owners maintain control of the business, and enjoy profits from the company, while gradually transferring ownership

  2. Basically, the owner transfers equity to an irrevocable trust, then takes a fixed amount of the trust's value annually, for a specified length of time, after which the equity is transferred to the owner's heir or heirs

- **Separate-share trust**
  1. For S corporations
  2. Trust that acts as a shareholder in the corporation
  3. Separate trust is established and managed for each heir
- **Intentionally defective grantor trust**
  1. Treats a business owner as the owner for income tax purposes but not for estate tax purposes
  2. Person creates a trust for family's benefit, then sell an asset (here, the business) to the trust in return for a long-term installment note

Closer Look at Family Limited Partnerships

One of the more useful strategies for families is a limited partnership (FLP).

Two major advantages

1. Tax savings provided by decreased estate and gift taxes through the use of discounts for lack of marketability and for fractional use
2. The ability of the original owner of the assets to retain control of those assets

It is best to proceed cautiously though as these discounts are often contested by the IRS.

Potential Drawbacks

1. Failure to fund
2. Failure to involve "business" assets only
3. Liability created from having a parent as a general partner
4. Limiting the percentage of the assets placed into an FLP (Typically, an FLP should only be funded with 25 percent of an owner's assets unless their estate is small. If that is the case, up to 40 percent can be placed in the FLP.)

Additional Caveats

- FLPs must be formed for valid, underlying business reasons
  1. Acceptable business reasons may include management enhancement of a family-owned business and the promotion of family involvement in the decision-making process of family-owned property
  2. Instances of impropriety, such as attempting to set up FLPs for the sole purpose of minimizing taxes, will draw the ire of the IRS
- Proper planning when establishing an FLP is paramount if the intent is to avoid IRS scrutiny

FURTHER READING

GLOSSARY

Term	Meaning
basis	The amount of a taxpayer's investment in a property for tax purposes, adjusted for certain items.
C corporation	A legal structure that businesses can choose to organize themselves under in order to limit their owners' legal and financial liabilities. C corporations are legally considered separate entities from their owners. In a C corporation, income is taxed at the corporate level and is taxed again when it is distributed to owners.
capital	1. Financial assets or the financial value of assets, such as cash. 2. The factories, machinery, and equipment owned by a business and used in production.
conversion	To change the classification of a business entity, as with Form 8832, Entity Classification Election.
debt basis	The shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year)
distributions	A company's payment of cash, stock or physical products to its shareholders.
dividends	A distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. The dividend is most often quoted in terms of the dollar amount each share receives (dividends per share). It can also be quoted in terms of a percent of the current market price, referred to as dividend yield.
entrepreneur	An individual who, rather than working as an employee, runs a small business and assumes all the risk and reward of a given business venture, idea, or good or service offered for sale. The entrepreneur is commonly seen as a business leader and innovator of new ideas and business processes.
Form 1040	Federal income tax form used by citizens or residents of the United States.
Form 1065	US Return of Partnership Income.
Form 1120S	US Income Tax Return for an S Corporation
Form 2553	Election by a Small Business Corporation to be treated as an S Corp.
Form 8832	Entity Classification Election form
fringe benefit	Items of monetary value provided to an employee in connection with the performance of services and in addition to the employee's salary.
general partner	Owners of a partnership who have unlimited liability. A general partner is also commonly a managing partner, which means that this person is active in the day-to-day operations of the business.
General Partnership	A arrangement by which partners conducting a business jointly have unlimited liability, which means their personal assets are liable for the partnership's obligations.

Limited Liability Company	A corporate structure whereby the members of the company cannot be held personally liable for the company's debts or liabilities. Limited liability companies (LLC) differ slightly from one country to the next. However, it is essentially a hybrid entity that combines the characteristics of a corporation and a partnership or sole proprietorship.

limited partner	A partner in a partnership whose liability is limited to the extent of the partner's share of ownership.
Limited Partnership	Two or more partners united to conduct a business jointly, and in which one or more of the partners is liable only to the extent of the amount of money that partner has invested.
liquidation	When a business or firm is terminated or bankrupt, its assets are sold and the proceeds pay creditors. Any leftovers are distributed to shareholders.
Partnership	A business organization in which two or more individuals manage and operate the business. Both owners are equally and personally liable for the debts of the business.
qualified joint venture	any joint venture involving the conduct of a trade or business if-- (A) the only members of such joint venture are a husband and wife, (B) both spouses materially participate in such trade or business, and (C) both spouses elect the application of this subsection.
S corporation	A small business corporation for which an election under section 1362(a) is in effect for such year. S corporations are corporations that elect to pass corporate income, losses, deductions, and credit through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income.
Schedule C	Net Profit or Loss from Business – A “self-employed” taxpayer files Schedule C with Form 1040 to report income and deductions resulting from their trade or business.
Schedule E	Supplemental Income and Loss – A taxpayer attaches Schedule E to report income or loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in REMICs.
Schedule K-1	Partner’s Share of Income, Deductions, Credits, etc. - A tax document used to report the incomes, losses, and dividends of a business's partners or S corporation's shareholders. Rather than being a financial summary for the entire group, the Schedule K-1 document is prepared for each partner or shareholder individually.
self-employment tax	A Social Security and Medicare tax primarily for individuals who work for themselves.
shareholder	Any person, company or other institution that owns at least one share of a company’s stock. Shareholders are a company's owners.
Sole proprietorship	The sole proprietor is an unincorporated business with one owner who pays personal income tax on profits from the business.
stock basis	The adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and
succession	The action of one party, person or product being replaced by another that has become obsolete, incapacitated, retired or deceased.

trusts	A fiduciary relationship in which one party, known as a trustor, gives another party, the trustee, the right to hold title to property or assets for the benefit of a third party, the beneficiary.

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