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CHOICE OF BUSINESS TAX ENTITY
AFTER THE 1993 TAX ACT

by

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One of the first decisions a single entrepreneur or a group of business owners must make in starting a new business is the legal and tax form of the new entity. Not only is this one of the first decisions, it can also be one of the most important for both tax and non-tax (i.e. liability) reasons.

Business owners have several options when it comes to choosing an entity form. The most common of these include the sole proprietorship, the general or limited partnership, the corporation (whether taxed as a C corporation or a S corporation), and the new limited liability company. The decision to use one of these forms should be based on a careful analysis of the tax and non-tax characteristics of each form and on the unique attributes of the business and potential owners.

Recent developments such as the Revenue Reconciliation Act of 1993 (RRA '93) and the increased recognition of the limited liability company by numerous state statutes may change the standard entity analysis used by professionals. This article will provide an analysis of the choice of entity decision in light of these new developments.

The first section of this article presents a discussion of the decision itself, as well as a description of each of the most common types of business forms. The second section provides a summary of the tax classification requirements imposed on certain entities by the Internal Revenue Service (IRS). The third and fourth sections examine the non-tax and tax considerations of the choice of entity decision. A chart is also provided which summarizes the non-tax and tax considerations addressed in the article (see Appendix A).

THE DECISION AND THE ENTITIES

As presented in detail below, there are numerous tax and non-tax considerations which must be made in determining the form of entity for a new business and in evaluating the conversion of form for an existing business.

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The analysis and comparisons which must be made can be quite time consuming for the practitioner, as well as the client. One practitioner observes that "... assisting the client in the task of choice of entity is as much an art as a science." He suggests that the possibility that the "comparison of available options ... may have to be detailed and painstaking" should be recognized and accepted by both the practitioner and the client.\(^2\)

The decision process may be made easier by eliminating available options from the outset based on a basic understanding of the entity types and knowledge of the particular needs and/or characteristics of the potential owners. For example, the fact that a new business will have more than thirty-five shareholders immediately excludes the S corporation tax election as a viable option. The most commonly used forms of business used by small businesses are the sole proprietorship, the general partnership, the limited partnership, the corporation (both regular and S election), and the limited liability company. A description of each of these follows. The characteristics of each entity will be reviewed in more detail in the analysis of the factors to be considered in choosing an entity form.

**Sole Proprietorship**

The sole proprietorship is the simplest business entity form from both a tax and non-tax perspective. A sole proprietorship is established and conducted by a single individual segregating a portion of his or her assets, dedicating them to business use, and keeping separate books of account for the business. Income and losses from the business are reported on the individual’s income tax return (Schedule C). The sole proprietor is fully liable for the debts and other liabilities of the proprietorship.

**General and Limited Partnerships**

The Uniform Partnership Act (UPA), promulgated in 1914, provides that a partnership is an association of two or more persons to carry on a business as co-owners for profit. In both types of partnership arrangements, the entity is not taxed, for federal tax purposes, rather the income, gains, losses, deductions and credits (hereinafter referred to as “tax items”) are passed out to the partners equally unless otherwise provided for in the partnership agreement. In general, losses passed through to the partners can be deducted to the extent

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2. *Id.* at 328.
of each partner’s basis in the partnership measured by his/her capital contributions and his/her share of all of the debts of the partnership as allocated by the partnership agreement (subject to the economic risk of loss provisions of I.R.C. § 752 and the passive loss rules). Each year, the partners must pay their allocated share of any applicable federal income tax on the partnership’s income and gains, whether or not actually distributed to them.

For some purposes, the partnership is recognized as a separate entity for federal tax purposes. For example, the partnership makes certain elections such as an accounting year and accounting methods. Some states recognize the flow-through nature of a partnership for state income tax purposes, while others tax the partnership entity itself similar to a corporation.3

In a general partnership, each partner is joint and severally liable for claims against the partnership. This type of partnership can be created by the intent of the partners and there are no formal filing requirements at the state or federal level. However, it is always advisable to have a partnership agreement in writing for the benefit and protection of all the partners. All of the partners in a general partnership may participate in management and each may act as agent for the others.

In a limited partnership, there must be at least one general partner who is personally liable for claims against the partnership. The limited partners are not liable for claims against the partnership unless they participate in the management of the entity beyond that which is allowed by state law. Most state laws are based on the Uniform Limited Partnership Act (ULPA) originally approved for adoption in 1916 or the Revised Uniform Limited Partnership Act (Revised ULPA) approved for adoption in 1976. A limited partnership must file a certificate of limited partnership in the office of a state official, usually the Secretary of State.

Regular or C Corporation

A corporation is formed by the filing of articles of incorporation in the appropriate state office. For both tax and legal purposes, the corporation is treated as a separate entity from its shareholders. The tax items of the incorporated business are reported and federal tax is paid by the corporation. A second level of tax is paid on the same income when the earnings of the corporation are passed out to the shareholders in the form of dividends.

The corporation itself is liable for debts and other claims against it rather

3. For example, New Hampshire assesses a gross business profits tax on all business entities regardless of form. Id. at 322-24.

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than the shareholders. Generally, the management of the corporation is cen-
tralized with the shareholders electing corporate directors, then these direc-
tors electing officers. The corporate form is the one most often used by large
business enterprises. These enterprises usually encompass a significant num-
ber of shareholders/investors due to the free transferability of shares, central-
ized management, and limited liability for the shareholders.

S Corporation Election

For legal purposes, the S corporation is the same as a corporation. An
S corporation tax status is merely a federal tax election for a corporation. An
S corporation is treated as a pass-through entity for federal tax purposes.

Similar to a partnership, the tax items of the S corporation, with some
exceptions, are not recognized by the corporation, but rather are passed
through to the shareholders to be reflected on their individual tax returns. The
S corporation shareholder can deduct losses to the extent of his/her basis in
the S corporation (subject to passive loss rules at the shareholder level). How-
ever, that basis does not include the pro rata portion of any S corporation
debt except to the extent such funds were personally loaned to the corporation
from the shareholder. The S corporation’s shareholders must annually recog-
nize the S corporation’s income and gains, whether or not actually distributed
to them.

One of the primary benefits of S corporation status over C corporation
status is that there is, with some exceptions discussed in subsequent sections,
only a single level of tax. Generally, dividend distributions made to share-
holders are non-taxable. For state income tax purposes, the S status may or
may not be recognized.4 Depending on the individual state’s statutes, the
S corporation may be taxed at the corporate level and the shareholders taxed
on distributions.

Unlike a partnership, there are several limitations with regards to the
number and types of shareholders. Specifically, the S corporation may have
no more than thirty-five shareholders and these shareholders may only include
U.S. citizens, U.S. residents and certain narrowly defined types of estates and
trusts (i.e. partnerships, other corporations and most trusts cannot be share-
holders). In addition, the S corporation can only have one class of stock and

4. For example, subchapter S corporations in Connecticut are subject to the state business
(income) tax and distributions from S corporations that are treated as dividends on the federal
tax return are subject to the Connecticut Capital Gains and Dividends Tax, and Georgia will
only recognize S corporation status if all the shareholders are subject to Georgia taxation
upon their pro-rata portion of the corporate income. See S Corporations Guide (CCH) ¶¶
20,012, 20,017 (1993).
cannot be a member of an operating affiliated group (whether or not a consolidated return is filed).

In order to be treated as an S corporation for federal tax purposes, the corporation must file a proper election with the Internal Revenue Service (IRS). The guidelines for qualifying for S status are strict and the status of the corporation must be constantly monitored by management in order to avoid any violations of the requirements which would cause an inadvertent termination of S status.

**Limited Liability Company**

The limited liability company (LLC) is a new type of entity organized under state law which combines the pass-through attributes of the partnership with the corporate characteristics of limited liability. The first LLC to be given partnership status for tax purposes was organized under the Wyoming Limited Liability Company Act. Subsequently, numerous other entities have had similar rulings and, as of June 1994 forty-two states have enacted limited liability company statutes.

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Generally, an LLC is formed by two or more persons filing articles of organization in the appropriate state office. The operations of the LLC are governed by an operating agreement which resembles the by-laws of a corporation and the agreement in a partnership. Owners of an LLC are referred to as members. Generally, the members of an LLC can choose to have the LLC managed by a manager or managers by providing for this in the articles of organization. These managers act similar to the directors in a corporation.

Although similar to the S corporation, the LLC does have several advantages over that form. An LLC does not have restrictions with regards to the number or types of members (shareholders). There is also no restriction as to whether or not an LLC can be a member of an affiliated group. Unlike the S corporation, the LLC may have more than one class of stock, and LLC members can use their proportionate share of LLC debt to increase stock basis for deducting pass-through losses (subject to the same limitations as partnerships). The LLC also has advantages over the limited partnership form in that all members can have limited liability and these members will not lose their limited liability status by participating in management of the LLC.

While the LLC appears to offer several advantages over the S corporation and the limited partnership, it has a rather short history (the first IRS partnership status ruling was in 1988 and most of the state statutes were approved in 1992 and 1993). Therefore, there are many areas of debate with regard to exactly how certain partnership provisions will be applied to LLCs. In addition, it appears that many of the LLC state statutes have provided numerous provisions regarding corporate characteristics which can be modified by a specific LLC agreement. Consequently, the IRS has ruled that an LLC formed under the appropriate state statute may not necessarily be considered a partnership for federal tax purposes depending on the specific LLC agreement.

Since each state has its own LLC provisions and some states still do not have LLC statutes at all, it is unclear whether the limited liability status of an

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7. Most states require two or more members; however, Texas (TEX. REV. CIV. STAT. ANN. art. 1528n-3.01 (West 1992)) and Virginia (VA. CODE ANN. §§ 13.1-1002, -1010) (Michie 1991) appear to allow one person to form an LLC. However, upon formation, a Virginia LLC must have at least two members. Also, if an LLC has only one member, it may not qualify for taxation as a partnership. Treas. Reg. § 301.7701-2(b) (as amended in 1993).
LLC will be recognized in business operations outside its state of origin. While these uncertainties may deter some from choosing the LLC as an entity form, it is growing in popularity. In most states it is a viable option that should be considered. The remainder of this article will address the characteristics of LLCs in general. However, state statutes may significantly differ from the general characteristics. When making a choice of entity decision, the applicable state statute(s) should be consulted.

CLASSIFICATION ISSUES

It is not a given that a business entity organized by its owners with the intentions of forming a partnership or a limited liability company will be recognized as such by the IRS for federal income tax purposes. Similarly, not all corporations are eligible for S corporation status for federal income tax purposes. The results of a partnership being reclassified by the IRS as a corporation or the inadvertent termination of S corporation status can be highly detrimental to the owners. This section provides a summary of the guidelines used by the IRS in determining the application of partnership or corporate status for tax purposes and also the requirements for valid S corporation status which should be considered in the choice of entity decision and in the subsequent formation of the entity.

Corporation vs. Partnership Tax Status

The Treasury Regulations set forth four characteristics which are used to distinguish between an entity to be treated as a partnership for tax purposes and an unincorporated association to be treated as a corporation subject to double taxation. In order for an unincorporated entity to be accorded partnership tax status, that entity must lack at least two of four corporate characteristics. These characteristics are; (1) continuity of life, (2) centralization of management, (3) limited liability, and (4) free transferability of interests.

Continuity of life exists if an organization is not dissolved upon the death, insanity, resignation, bankruptcy, retirement, or expulsion of any member. A dissolution may occur even though the business continues to be

9. Treas. Reg. § 301.7701-2(a)(1) actually sets forth six characteristics with the two additional characteristics being (1) associates and (2) an objective to carry on business and divide the gains therefrom. However, Treas. Reg. § 301.7701-2(a)(2) limits the determining characteristics to the four mentioned in the text of the article since associates and an objective to carry on business and divide gains therefrom are generally common to both corporations and partnerships.
conducted in what technically is a new partnership. Centralization of management exists if any group of less than all the participants has the continuing exclusive authority to manage the conduct of the organization's business. Limited liability exists if no member of the organization is liable for the organization's debts. Free transferability of interest exists if each participant is able to confer on a transferee all of the attributes of his interest in the organization without the consent of other members.

If organized under the UPA or the ULPA/Revised ULPA, almost all general and limited partnerships will lack continuity of life and free transferability of interests. Also an LLC will generally lack continuity of life and free transferability of interests. However, as mentioned previously, many state LLC statutes provide considerable flexibility with regards to these corporate characteristics. As a result, several LLCs have been ruled to be taxable as corporations rather than partnerships which renders the tax benefits of an LLC null. Partnerships are also susceptible to such reclassification if the partnership agreement strays significantly from the provisions of the UPA or the ULPA/Revised ULPA.

Since LLCs inherently have limited liability and will usually have centralized management vested in the elected managers, there is no room for error with regards to the other two corporate characteristics of continuity of life and free transferability of interests. It is important that the LLC articles of organization provide that these characteristics will not exist in the LLC arrangement. The Treasury Regulations, Revenue Rulings, and Letter Rulings can provide guidance in questionable situations for both partnerships and LLCs.

S Corporation Tax Status

As previously mentioned, not all business entities or potential entities are eligible for S corporation status. An S corporation may have no more than thirty-five shareholders. A husband and wife are treated as one shareholder.

17. I.R.C. § 1361(c)(1).
No shareholder can be another corporation, a partnership, or a nonresident alien. A trust may not be a shareholder unless it is a grantor trust with a single beneficiary; a testamentary trust, but only for sixty days; a voting trust; an estate, including a bankruptcy estate; or a trust with a single individual beneficiary who will receive all trust income currently.

The S corporation may not be a member of an affiliated group; it cannot have an 80 percent subsidiary whether or not a consolidated return is filed. However, inactive subsidiaries may be formed without destroying the S election. An S corporation can have only one class of stock which prevents the corporation from giving some shareholders preferred distribution rights. Some debt arrangements may run the risk of being reclassified as a second class of stock; however, "straight debt" is immune from this risk.

Finally, initial S corporation status requires an election by all of the corporation's shareholders. The election may be revoked if more than fifty percent of shareholders sign a consent to do so. S corporation status terminates and the corporation will be treated as a C corporation for tax purposes if the corporation ceases to meet any of the requirements for election. While the S corporation status may be the most advantageous form for the entity in question, the requirements for qualification are the most stringent of all of the entities.

NON-TAX CONSIDERATIONS

There are seven primary non-tax factors which are generally considered in the choice of entity decision: separate legal entity status, expense and formalities of organization, management structure, continuity of existence, ease of financing, transferability of interests, and limited liability. This section discusses each of these factors in the context of each of the business forms presented above. Unless otherwise specified, references to the corporate form will include both C corporations and S corporations.

18. I.R.C. § 1361(b)(1)(B)-(C), (c)(2)-(d).
19. Id.
23. Straight debt is a written unconditional promise to pay a certain amount of money, at a certain date or on demand, usually with a fixed interest rate. Although the interest rate may float and the date of payment may vary based on objective criteria, neither may be contingent on profits or upon the borrower's discretion. I.R.C. § 1361(c)(5)(B).
Most of the following considerations deal with legal considerations. When reviewing these factors in making a choice of entity decision, it is best to remember the advice of one practitioner . . . “except in rare circumstances . . . choose the simplest possible legal form and . . . implement it in the simplest possible way.” 27

Separate Legal Entity Status

This consideration deals with whether or not an organization will be considered a separate legal entity and, therefore, possess the right to sue or be sued; enter into contracts; and hold, deal in, and dispose of property in the business name. While not always the case in the past, this has become a somewhat neutral factor in the decision on what business form to use.

An incorporated entity is always treated as a separate legal entity and state statutes and/or court rules have enabling statutes which permit a partnership to sue or be sued in the firm name. 28 In addition, the UPA §10 permits title to real property to be held or conveyed in the partnership name. LLC statutes provide that the LLC is an entity separate from its owners. The sole proprietorship is not treated as a separate legal entity from the proprietor. In most jurisdictions, a sole proprietor’s spouse must be joined to effectuate the conveyance of any real estate, regardless of whether the real estate is part of the business. 29

Expense and Formalities of Organization

Certain formalities must be considered regardless of the form of entity chosen. For example, all businesses must comply with the applicable business license, tax identification, workers compensation, unemployment compensation, and fictitious or trade name requirements. Without regards to these, the sole proprietorship and the general partnership are generally, the least expensive and least complicated to form. Very few states require any filing for these types of businesses and they can exist without any written documentation. However, as mentioned previously, it is best to incur the necessary costs of having a partnership agreement legally documented. There is also no general requirement that a general partnership register in every state where it intends to do business, as there is for corporations.

27. Cunningham, supra note 1, at 328.
28. Choice of Entity, Tax Mgmt. (BNA) No. 456, at A-4 (March 12, 1990). “To subject all of the partners to personal liability in a suit against the partnership, service of process must generally be made on the partners in their individual capacity.” Id.
29. Id. at A-5.
The limited partnership will be somewhat more expensive and troublesome as a certificate of limited partnership must be filed pursuant to ULPA §2(1)(b) and Revised ULPA §201. The limited partnership certificate must be amended any time there is a change in the partners. A limited partnership is also required to have a written limited partnership agreement. In the case of both types of partnerships, it is especially important to use competent legal counsel so that partnership agreements comply with the tax classification requirements as discussed in the previous section. Depending on how complicated the desired partnership structure and allocations are, the legal costs of formation could be considerable, but are necessary in order to avoid future problems.

The LLC is similar to the limited partnership in that it must file articles of organization with a department of the state government. Most LLCs are required to have some form of operating agreement or regulations, which is an agreement by the members as to the affairs of the LLC and the conduct of its business. The costs of forming the LLC will probably be the same as for forming a limited partnership; however, since LLCs are relatively new in most states, additional costs may be incurred in determining the appropriate filings and agreements required.

A corporation must prepare and file a certificate of incorporation. In addition, if a corporation intends to do business in more than one state, consideration must be given to the requirements qualifying to do business in more than one state which vary considerably from state to state. Additional filing fees and legal fees could be incurred in such a case. The cost of required elections for directors and officers must also be considered. An S corporation will usually incur additional professional fees in filing its S-election. While the UPA, ULPA, Revised ULPA, and the LLC statutes allow for the numerous and varied relationships to be formed among the partners or members simply by drafting the appropriate provisions in the partnership or LLC agreement, the typical corporate statutes contain rigid requirements that can be modified, but in a much more unwieldy and less direct method.

**Management Structure**

The sole proprietorship is simply managed and controlled by the proprietor. The management structure of the general partnership is similarly straightforward in that all general partners can participate in the management of the business. Absent any contrary provisions in the partnership agreement, the UPA §18(h) provides that a majority vote of the partners will govern the partnership’s routine business affairs. In addition, it is possible for a partner to threaten dissolution if action is taken contrary to his
wishes. An LLC can also be operated in a similar fashion if the members retain control pursuant to the operating agreement and do not elect managers. As in the case of a general partnership, when management is vested in the LLC members, each member can bind the LLC when acting with apparent authority in carrying on LLC business.

The limited partnership has centralized management. Under ULPA §9 and Revised ULPA §403, management and control of a limited partnership is vested in the general partners. The limited partners are similar to shareholders that invest funds and have limited liability. Under ULPA §7 and Revised ULPA §303(a), a limited partner can lose his limited liability if he participates in the control of the business.

A corporation, on the other hand, is required to have centralized management. The shareholders must elect a board of directors who make most of the operating decisions in a representative capacity. In a closely-held corporation, it is possible for the shareholders to manage and control the corporation directly by having a board of directors made up of a majority of the shareholders. The corporation is required to hold meetings of its shareholders and directors and keep accurate records and minutes. The corporate formalities are usually quite cumbersome for the small business with few owners.

The LLC which elects managers will operate in much the same way as a corporation with the managers operating similar to the board of directors. There is some ambiguity in many of the state statutes with regards to required meetings of shareholders and/or managers and other similar formalities. Depending on the applicable state statute, it appears that the LLC may have considerable flexibility in establishing the desired management structure and associated management formalities such as elections and meetings.

Continuity of Existence

Continuity of existence refers to a business’ ability to continue after the death of one of its owners or upon other events such as the bankruptcy or withdrawal of one of its owners. Other than in a sole proprietorship, the continuity of existence of a business can usually be assured by proper drafting. A corporation automatically has perpetual existence unless otherwise provided for in the articles of incorporation. The corporation as a separate entity will continue to exist regardless of the death, withdrawal, or bankruptcy of one of its shareholders.

As previously discussed, a general partnership, limited partnership, or LLC should generally not have continuity of existence if partnership tax status

The death of a sole proprietor will terminate the business. However, the proprietor can provide in his will for the temporary operation of the business by a personal representative pending sale or liquidation or he/she may also provide authority in the will to incorporate the business.

Ease of Financing

An important consideration before organizing a business is the extent and type of financing that will be desired and/or necessary not only at the present time, but in the future as well. A sole proprietorship is limited to personal funds and personally guaranteed loans. Sources of capital for the LLC and the general or limited partnership include capital contributions and loans from member/partners and loans from outsiders. In the case of an LLC or limited partnership, outside lenders may require personal guarantees from the members or limited partners since they will have no recourse against these parties should the business not repay the loan.

The general partnership, the limited partnership and the LLC can structure ownership allocations of profits and losses so that various investment opportunities can be offered to potential partner/members. However, such special allocations may not be recognized for tax purposes and should be carefully scrutinized before such opportunities are offered. The LLC and limited partnership have an advantage over the general partnership in that they can both offer various limited liability investment opportunities versus the joint and several liability that all general partners must assume. It should be kept in mind that complicated partnership/LLC ownership structure agreements can quickly become very costly and cumbersome in practice, indicating that the entity should be incorporated for financing reasons.

With regard to ease of financing, the C corporation is generally considered to have the most financing flexibility due to the variety of forms of investment participation available. A C corporation can issue various types of equity instruments including common and preferred stock, stock warrants, and stock options. In addition, the corporation can issue bonds which may or may not be convertible into equity.
The S corporation does not have as much flexibility as the regular C corporation. First, the S corporation can only have thirty-five shareholders; therefore, once this limit is reached no additional owners can provide capital investment. Second, the S corporation is only allowed to have one class of stock. As a result, the S corporation is limited to owner capital contributions, loans from owners, and loans from outsiders for financing purposes.

Transferability of Interests

Transferability of interests refers to the owners’ ability to sell or transfer their interests in the business. The sole proprietorship obviously has complete transferability in that he or she can sell or transfer any portion of the business. The C corporation also has full transferability of interests. There are no restrictions on shareholders with regards to the selling or transferring of their shares.

On the other hand, the S corporation is somewhat restricted. In theory, the shareholders are free to sell or transfer their shares. However, in order to retain S status, a sale or transfer can never cause the number of shareholders to exceed thirty-five and the sale or transfer cannot be to a non-qualifying shareholder. This can significantly limit the transferability of S corporation interests.

Absent an agreement to the contrary, a general partner must obtain the consent of all partners to transfer a partnership interest and grant the transferee all the rights to which the transferor is entitled.31 Often partnership agreements (including those of limited partnerships) will provide that partners may transfer their interests in certain circumstances without the consent of all other partners. However, this results in “modified free transferability” and while it is afforded less weight than unrestricted transferability, it will probably cause corporation classification for federal income tax purposes if two other corporate characteristics (as discussed previously) are present.32

Under ULPA §19 and Revised ULPA §702, a limited partner may freely assign his limited partnership interest; however, absent the consent of all the other partners and a provision in the certificate of limited partnership, the assignee of such an interest will only have the assignor’s right to share in profits and will not be a substitute limited partner. Similarly, a member of an LLC is generally authorized by law to transfer his or her interest in the LLC; however, absent the written consent of all other members, the transferee

32. Treas. Reg. §§ 301.7701-2(e)(2) and (g) (Examples 5 and 6).
will have no right to participate in the management of the LLC or to become a member.

**Limited Liability**

By statute, members of an LLC, shareholders of a corporation, and limited partners all have limited liability with regards to the debts and claims against the respective entity. Such members, shareholders, or limited partners will be liable for any loans to the entity for which they have made personal guarantees. This makes limited liability somewhat unrealistic in small businesses, since lenders often require such personal guarantees from principal shareholders.

A sole proprietor is personally liable for any debts or claims against the proprietorship. Likewise, the general partners of a limited partnership or general partnership are joint and severally liable for the debts and claims against the partnership. Also, the limited partners in a limited partnership can lose their limited liability status if they take part in the management control of the business.

**TAX CONSIDERATIONS**

Legal formalities are not the only factors to be considered in forming a new entity. Since careful drafting can often render any of the possible entities a viable option for legal reasons alone, it is usually the tax effect of each entity which becomes the deciding factor. There are numerous tax considerations in forming a business entity which are summarized in this article under ten main areas: (1) formation of the entity and subsequent contributions, (2) taxability of income, (3) deductibility of losses and basis, (4) special allocations, (5) distributions, (6) accounting matters, (7) sale of interests, (8) retirement or death of owner, (9) liquidation, dissolution, or termination and (10) state and local taxation.

Most of the differences in tax treatment of the entities stems from whether or not an entity is treated under the entity or aggregate approach. Under the entity approach, the owners are treated as separate taxpayers and tax is assessed at the entity level and also at the ownership level upon distributions from the entity to the owners (corporate form). The aggregate approach treats the owners as the only taxpayers subject to taxation (with some exceptions for S corporations). Therefore, there is only a single level of tax in the formation and operation of such entities (sole proprietorships, partnerships, LLCs, and S corporations).

Before the tax considerations are discussed in detail, it should be noted
that all of the entity forms presented in this article must compute their business taxable income in essentially the same manner. They all must compute gross income and subtract allowable business deductions; the same deductions and credits are generally available to all of the forms. Also with certain exceptions, all are able to take advantage of federally tax-favored retirement plans on basically equal terms.33

Finally, all of the business forms are required to file a federal income tax or information return. The sole proprietorship is reported on the proprietor's individual income tax return; S corporations34, partnerships and LLCs generally only file information tax returns. A separate tax is calculated on C corporation income tax returns.

**Formation of the Entity and Subsequent Contributions**

There are generally no income tax consequences upon the formation of a sole proprietorship. The proprietor must keep separate records and books for the business and should separate the business assets from his or her personal assets.

The Internal Revenue Code (IRC) §351 provides that the formation of a corporation will generally be nontaxable to the corporation and the shareholders. In order to qualify under §351, property must be transferred by two or more persons solely in exchange for stock in the corporation and, immediately after the transfer, the corporation must be controlled by the transferors. Control of the corporation for §351 purposes is defined in IRC §368(c) as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote, and at least 80% of the total number of shares of each class of nonvoting stock.

Under §351(d)(1), services performed by a transferor do not count as property for §351 purposes. However, if a transferor transfers services and property and the transferred property is not of "relatively small value" in relation to stock already owned or to be received in exchange for services, then the stock received for services can be included in the control test. The Service will not consider property to be of "relatively small value" if the fair

33. Before the enactment of TEFRA (The Tax Equity and Fiscal Responsibility Act of 1987) benefits available under tax-qualified "corporate" retirement plans were significantly greater than those available under the plans of unincorporated entities or S corporations that benefited one or more "self-employed individuals." Pub. L. No. 97-248. After TEFRA, with a few minor exceptions, tax-qualified plans are a tax-neutral factor in choice of entity decisions. See Discussion Choice of Entity, Tax Mgmt., (BNA) No. 456, at A-36.

34. The S corporation may be taxed at the corporate level in the case of realized built-in gains, I.R.C. § 1374, or in the case of excess passive investment income. I.R.C. § 1375.
market value of the property transferred equals 10% or more of the fair market value of the stock already owned by the transferor or to be received in exchange for services by the transferor. The portion of stock received which is attributable to services will be treated as taxable boot.

Example A: Consider three individuals Sue, Carol, and Linda who are about to form a newly created corporation. Sue and Carol will each contribute $50,000 (FMV) in property solely in exchange for 33 1/3% of the common shares each and Linda will contribute services worth $50,000 solely for 33 1/3% of the common shares.

These transfers fail to qualify for §351 treatment because Linda did not contribute property, therefore her shares are not counted for purposes of the control test. The qualifying transferees, Sue and Carol, own only 66 2/3% immediately after the transaction which does not meet the 80% control test.

Alternatively, consider the same situation except that Linda contributes both services worth $25,000 and property worth $25,000. Linda's entire 33 1/3% ownership interest will be counted for purposes of control and the transactions would qualify under §351. The portion of the shares issued for the services will be treated as taxable boot to Linda (see below for treatment of boot).

If the property transferred by Linda was worth only $2,000 (less than 10% of the total $50,000 ownership interest received) and the services worth $48,000, the transfer of property would not bring the transfers within the provisions of §351.

If any transferor receives property or money other than stock from the corporation (including stock for services), it is treated as boot subject to tax. The amount of gain recognized for tax purposes is equal to the lesser of the realized gain or the fair market value of the boot received. No loss is ever recognized in a §351 transaction.

Example B: Individuals A and B join forces to operate a new business. A and B transfer the properties listed below to C in exchange for common stock and cash. The cash was obtained by C from a short-term bank loan made on the date of the property transfers.

```
<table>
<thead>
<tr>
<th>Property</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$450,000</td>
<td>$450,000</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$325,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Fair Market Value</td>
<td>$300,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>
```

37. I.R.C. § 351(b)(2).
Cash Received | $ 50,000 | $ 50,000
Shares Received | 1,000 | 1,000

As a result of the transaction, C Corporation recognizes no gain or loss. A has a realized loss of $25,000 (FMV $300,000 less adjusted basis of $325,000) which goes unrecognized. B has a realized gain of $100,000 (FMV $300,000 less adjusted basis of $200,000). B's recognized gain is $50,000 (the lesser of the realized gain of $100,000 and the boot received).

Under IRC §357(a), if the corporation assumes the liabilities of the transferor or takes contributed property subject to liabilities, the assumption will not be treated as boot and will not disqualify the exchange with two exceptions. First, gain will be recognized on the assumption of the liabilities if the principal purpose of the transaction is to avoid federal income tax. Second, gain will be recognized on the assumption of the liabilities if the assumed liabilities exceed the adjusted basis of all property transferred to the corporation.

If §351 is applicable, the corporation will obtain a basis in the contributed property equal to the transferor's basis plus any gain recognized by the transferor. Each transferor's basis in his stock will be equal to the basis in the property transferred minus boot received (including liabilities assumed by the corporation) plus any gain recognized on the transfer.

**Example C:** Consider Example B above. The corporation's basis in the land and building transferred by A is A's adjusted basis of $325,000. The corporation's basis in the equipment transferred by B is $250,000 (B's adjusted basis plus any gain recognized by B).

A's basis in the corporate stock would be $275,000 (A's basis in the property transferred minus boot received) while B's basis in the stock would be $325,000 (B's basis in the property transferred minus boot received plus gain recognized by B on the transfer).

In the case of services exchanged for stock, if the transaction qualifies under §351, the portion of the stock received for services is considered taxable boot and receives a basis equal to its fair market value at the date of transfer.

The corporation's holding period for the transferred property includes the holding period of the transferor for capital assets and IRC §1231.

38. I.R.C. § 357(b).
39. I.R.C. § 357(c).
41. I.R.C. § 358.
property. Likewise, the transferor’s holding period for the corporate stock includes the holding period of the property transferred to the extent the basis is attributable to capital and IRC §1231 assets transferred. The holding period for taxable boot begins on the date of transfer.

Although there is the requirement that the transferor(s) be in “control” of the corporation immediately after the transfer, control does not have to be acquired in the transaction as long as the current transferors of property have control after the transaction. The control requirement generally means that nonrecognition under §351 is available for initial incorporation transactions and for subsequent pro rata contributions, but not for admission of new participants or subsequent non-pro rata contributions.

In some situations, it may be desirable to avoid the application of §351 and have the formation of the corporation be a taxable event. One example is when the transferor wants to recognize capital gain on highly appreciated property (in order to use against capital losses) and provide the corporation with a stepped-up basis for depreciation purposes. The transaction might be structured to produce desired gain recognition on the part of the transferor(s) by having the corporation distribute boot or by assuring that the transferor group lacks the requisite control immediately after the transaction.

One method to avoid §351 is by structuring an asset sale to a newly formed corporation. There are certain risks in forming a corporation by having shares acquired for a minimal amount of cash and then using an asset sale. The IRS could collapse the two transactions into one §351 transaction. Also, if the sale results in a loss to the transferor, IRC §267(a)(1) and (b)(2) disallow losses on the sale or exchange of property between an individual and corporation in which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for the transferor.

An S corporation is formed in the same manner as a C corporation. However, in order to obtain S status, a qualified S election must be filed. The election may be made for a taxable year at any time during the preceding taxable year or at any time during the taxable year on or before the 15th day of the third month of the taxable year. All persons who are shareholders on the date of election must consent to the election. If an election is made after the 15th day of the third month of a taxable year for a particular taxable year, the election is treated as made for the following taxable year.
General and limited partnerships and LLCs are generally treated the same for tax purposes. Unless otherwise specified, the term partnership will be used to refer to all three entities. Like a corporation, a partnership can be formed in either a taxable or nontaxable manner. The general rule is that no gain or loss will be recognized by the partnership or partner(s) upon the contribution of property to the partnership in exchange for a partnership interest. The nonrecognition rule applies to contributions made upon formation and subsequent contributions.

A contribution to a partnership may be wholly or partially taxable if the partner(s) contributes property subject to liabilities and/or if the partnership assumes liabilities of the contributing partner(s). The amount of gain which must be recognized is capital gain equal to the excess (if any) of the contributing partner’s liabilities allocated to other partners (a portion of the assumed liability will be allocated back to the contributing partner—see the section on Special Allocations below) over the contributing partner’s adjusted basis in his partnership.

Example D: Assume that Bob contributes land to a partnership in exchange for a 20% interest in the partnership. At the time of contribution, the land has a fair market value of $10,000 and adjusted basis to Bob of $4,000, and is subject to a mortgage of $8,000. At the time of Bob’s admission to the partnership, the partnership has no liabilities.

Since Bob is receiving a 20% ownership interest, he will be relieved of 80% of the mortgage, $6,400. Since this exceeds his adjusted basis in his partnership interest of $4,000 (adjusted basis in the property transferred plus his 20% share of the mortgage), Bob will have a capital gain equal to the excess of $2,400.

A contribution to a partnership may also be taxable if services rather than property are contributed to the partnership in exchange for a partnership interest. If the contributing partner receives an unrestricted capital interest in exchange for services, the partner will be taxed on the fair market value of the capital interest at the time of receipt. The partnership will be able to deduct the same value as a necessary and ordinary expense under §162 or will be required to capitalize the amount under §263.

There has been considerable controversy in the past with regard to whether or not a contributing service partner is required to recognize income upon the contribution of services in exchange for a profit interest in a partnership. Recently, the IRS has issued Revenue Procedure 93-27 (1993-24 I.R.B. 63) which provides that the receipt of a profit interest by a partner in

47. I.R.C. § 721.
48. I.R.C. §§ 731(a) & 741.
CHOICE OF BUSINESS TAX ENTITY AFTER THE 1993 TAX ACT

return for services performed for the benefit of the partnership is not generally a taxable event. There is some uncertainty with regards to situations not covered by this Revenue Procedure. In such instances, prior case law may be applicable which has found that the receipt of a profit interest is a taxable event.\(^{50}\)

In addition, Proposed Treasury Regulations issued in 1992 provide that a partnership must allocate income, gain, loss, and deduction with respect to partnership property contributed by a partner so as to take into account any appreciation at the time of contribution.\(^{51}\) In other words, if a partner contributes appreciated property, the gain, when recognized, on that appreciation cannot be shifted to any other partners. In addition, if the property is depreciable, depreciation adjustments attributable to the built-in gain will not be shifted to any other partners.

For reasons similar to those discussed above, it may be that the potential partners do not want non-recognition treatment with regards to the formation of a corporation. The partnership could be formed using certain property, and a subsequent sale could be used for the property for which gain recognition is desired. Similar to the corporate rules, IRC §707(b)(1) does not allow a deduction with respect to losses from sales of property between a partnership and a partner owning, directly or indirectly, more than 50% of partnership interest in capital or profits.

In the case of contributions subsequent to formation in which a partnership distributes property other than interests in the partnership, the additional property is treated as a distribution and is taxable based on the rules governing partnership distributions (see the section on Distributions below).

A partner’s basis in his partnership interest upon formation is the adjusted basis of property contributed to the partnership at the time of contribution plus the amount of any gain recognized to the contributing partner at the time of contribution less any decrease in the partner’s personal liabilities resulting from the partnership’s assumption plus any liabilities of the partnership properly allocable to the partner.\(^{52}\) The partnership’s basis in the property is computed in the same manner as the partner’s initial basis in the partnership.\(^{53}\)

**Example E:** In Example D above, Bob’s basis in his partnership interest would be calculated as follows:

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50. See Diamond v. Commissioner, 56 T.C. 530 (1971), aff’d, 492 F.2d 286 (7th Cir. 1974).


52. I.R.C. § 722.

53. I.R.C. § 723.
Adjusted basis of property transferred $4,000
Plus gain recognized upon transfer 2,400
Less decrease in personal liabilities assumed by the partnership (8,000)
Plus partnership liabilities allocable to Bob 1,600
Bob's basis in his partnership interest 0

The partnership's holding period for the transferred property includes the holding period of the transferor for capital assets and IRC §1231 property.\textsuperscript{54} Likewise, the transferor’s holding period for the partnership interest includes the holding period of the property transferred to the extent the basis is attributable to capital and IRC §1231 assets transferred.\textsuperscript{55}

\textbf{Taxability of Income}

As previously mentioned, the primary difference among the types of entities for tax purposes stems from the treatment of the entity on an aggregate or entity approach. The \textit{sole proprietorship} can be considered an aggregate approach entity because it is not treated as a separate entity for income tax purposes. All of the income and gains from the sole proprietor's business are taxed as earned on his/her individual tax return at the appropriate individual income tax rates. The \textit{corporation} is treated as a separate entity for income tax purposes. All of the income and gains from the corporation are taxed at the corporate level at the corporate income tax rates. The use of the corporate form results in double taxation because the distributions of earnings of the corporation to the owners are taxed as dividends to the owners subject to their individual tax rates. This is usually a serious negative factor against using the corporate form for small businesses. However, there are several methods for mitigating the effects of the double taxation.

In many small businesses, several, if not all, of the shareholders may also be employees of the corporation. In such a case, the corporation can pay out reasonable compensation to these shareholder/employees which will be deductible from taxable income for the corporation and only subject to tax at the shareholder level. Emphasis should be placed on the word reasonable. The IRS can and does closely scrutinize compensation deductions to shareholder/employees. If the compensation is deemed to be unreasonable, the deduction at the corporate level will be disallowed and the distribution of the salary to the shareholder may be taxed to the recipient personally as dividend income.\textsuperscript{56}

\textsuperscript{54} I.R.C. § 1223(2).
\textsuperscript{55} I.R.C. § 1223(1).
\textsuperscript{56} Treas. Reg. §§ 1.162-7 & 1.162-8.
There are several factors which have been used by the courts in determining whether salary is reasonable, including the arm’s length nature of the transaction (i.e. parties are sufficiently unrelated), salary history and industry salary scales, source of corporate earnings (i.e. in service oriented businesses, a sole employee may be the only source of earnings for the business and thus a substantial salary may be reasonable), and the dividend history of the corporation.

A second method that can be used to mitigate the effects of double taxation is the payment of deductible expenses, other than compensation, to the shareholders. For example, interest on funds loaned by the shareholder to the corporation, rent on property leased to the corporation by the shareholder, etc. However, any transaction between the corporation and shareholders must be bona fide and at arm’s length (i.e. at fair market rates) in order to be recognized for income tax purposes.

A third method is for the corporation to simply retain its earnings rather than making dividend distributions. Retention of the earnings will defer taxation to the shareholders until a subsequent event such as the sale or redemption of the shares. Recognition of income upon such transactions will usually be as capital gains rather than ordinary income (such as the dividends would have been) which based on the tax rate changes of RRA ‘93 for individuals can be a considerable tax benefit. The differential between the highest individual income tax rate and the maximum capital gains rate is now 11.6%.

Retention of the corporate earnings is not without some risks. Specifically, the income tax rules provide for two types of penalty taxes imposed only on the C corporation form in certain situations. IRC §531 provides for a penalty tax of 39.6% (the highest individual tax rate under RRA ‘93) on accumulated taxable income. Generally, accumulated taxable income is accumulated earnings in excess of the reasonable needs of the business. IRC §535 provides the calculation of accumulated taxable income including an accumulated earnings credit. The issue of accumulated earnings and any assessment

57. See Miles-Conley Co. v. Commissioner, 173 F.2d 958 (4th Cir. 1949). See also Keller v. Commissioner, 77 T.C. 1014 (1981), aff’d, 723 F.2d 58 (10th Cir. 1983).
59. See Eduardo Catalano, Inc. v. Commissioner, 38 T.C.M. (CCH) 763 (1979); McClung Hosp., Inc. v. Commissioner, 19 T.C.M. (CCH) 449 (1960); Klamath Medical Serv. Bureau v. Commissioner, 29 T.C. 339 (1957), aff’d, 261 F.2d 842 (9th Cir. 1958).
of the penalty tax are usually the result of an IRS audit concerning other tax matters of the corporation. The purpose of this penalty tax is specifically to keep corporations and their shareholders from avoiding the double taxation of the corporate form.

The second type of corporate penalty tax is imposed on personal holding companies. Under IRC §542, a personal holding company is a corporation with five or fewer individuals owning, directly or indirectly, more than 50% of the value of the outstanding stock at any time during the last half of the taxable year with at least 60% of adjusted ordinary gross income constituting personal holding company income. There are detailed rules with regards to the computation of personal holding company income and the penalty tax thereon. However, personal holding company income is generally passive/portfolio income such as dividends, interest, rents, and royalties. The personal holding company tax is assessed at the highest individual tax rate of 39.6%.

Both the personal holding company tax and the accumulated earnings tax are assessed in addition to the regular corporate income tax. Also, any subsequent dividends after such taxes have been assessed generally do not result in a refund of the penalty taxes. For purposes of the personal holding company tax, it is possible that deficiency dividends paid may result in a refund of personal holding company tax. Deficiency dividends must be made based either on a determination by a court of law, on a closing agreement between the Service and the taxpayer, or on written agreement between the Secretary and the taxpayer.

The S corporation is not treated as a separate entity for income tax purposes, rather the aggregate approach is used. S corporation shareholders are taxed on their pro rata share of income, gains, and deductions for each tax year whether or not the earnings are distributed to them. These tax items retain their character when passed out to the shareholders. For example, capital gains of the S corporation are treated as capital gains on each individual's return and investment interest of the S corporation is treated as part of the individual's investment interest subject to limitations at the individual level.

While this treatment avoids the double taxation of the corporate form, it

61. I.R.C. § 541.
62. I.R.C. § 547(b).
63. I.R.C. § 547(c).
64. A shareholder’s pro rata share is determined on a per-share per-day basis by assigning an equal portion of any corporate item to each day of the taxable year and then dividing that portion pro rata among the shares outstanding on that date. I.R.C. § 1377(a).
may place a heavy burden on the shareholders of a business that is reinvesting all of its earnings for growth opportunities rather than making distributions. In such a case, shareholders will be required to pay the taxes on the S corporation income out of their income from other sources.

There are two circumstances in which an S corporation may be taxed at the S corporation level. The Tax Reform Act of 1986 (TRA '86) amended the S corporation rules in order to prevent C corporations with appreciated assets from converting to S status and then subsequently distributing those assets in a single rather than double tax transaction (see the taxability of C corporation distributions versus S corporation distributions in the Distributions section below). IRC §1374 provides that the highest corporate tax rate (35% under RRA '93) will be imposed on S corporation built-in gains realized within ten years of conversion from C corporation status to S corporation status. The built-in gains tax does not apply to corporations which have always been S corporations from inception.\footnote{I.R.C. § 1374(c).} Built-in gains are those unrealized gains on appreciated property of the corporation which existed at the date of conversion. The tax is imposed on built-in gains realized, without any offset for built-in losses realized; however, the total amount subject to tax will not exceed the net unrealized built-in gains at the time of conversion.\footnote{Id.} Net unrealized built-in gain is the amount by which the fair market value of the assets of the corporation exceeds the aggregate adjusted bases of such assets as of the beginning of its first taxable year for which S status has been elected.\footnote{I.R.C. § 1374(d).}

Current year net operating losses of the S corporation may offset the built-in gain, but these losses are not then available to be passed out to the shareholders. In addition, any net operating losses and certain other carryforwards from C corporation years may be used to offset the built-in gains.\footnote{I.R.C. § 1374(b).} The built-in gains are passed out to the shareholders, but are first reduced by any taxes paid by the S corporation.

The second circumstance in which an S corporation may be subject to corporate level tax is in the case of substantial passive investment income. The provisions of IRC §1362(d)(3) and 1375 were enacted to prevent personal holding companies from converting to S status and retaining the C corporation earnings and profits within the S corporation without penalty. IRC §1375 provides that if an S corporation has, in any particular tax year, C corporation earnings and profits at the close of that year and gross receipts more than 25% of which are passive investment income, then a tax is imposed at the

\footnotesize{65. I.R.C. § 1374(c).} 
\footnotesize{66. Id.} 
\footnotesize{67. I.R.C. § 1374(d).} 
\footnotesize{68. I.R.C. § 1374(b).}
highest corporate tax rate of 35% on the excess net passive income as calculated under that section. Similar to the treatment of the built-in gains tax, all of the passive investment income less any corporate level tax paid is passed out to the shareholders for taxation on their individual returns.

IRC § 1362(d)(3) provides a harsher rule with respect to the excess passive income of S corporations. If an S corporation has excess passive investment income for three consecutive years (which need not be the first three years after conversion) during which it had accumulated C corporation earnings and profits, the corporation loses its S status at the end of the third year. The penalty tax and termination due to excess passive investment income can be avoided by the distribution of the accumulated C corporation earnings and profits (see Distributions section below).

Partnerships are also treated from the aggregate approach for income purposes. The partners are taxed on their share of income, gains, and deductions for each tax year whether or not distributed to them the same as S corporation shareholders. However, the income and gains need not be pro rata as in the S corporation scenario, rather the rules governing partnerships allow for the use of special allocations which will be discussed in a separate section below. As in the case of the S corporation, the income and gains retain their tax character when passed out to the partners.

The changes to both the individual and corporate tax rates under RRA '93 may have an impact on whether or not a small business decides to choose the corporate form versus one of the pass-through entities. It should also prompt existing businesses to reevaluate their current tax status. The tax act has added two additional tax brackets for individuals. In addition to the 15, 28, and 31% brackets, income between $140,000 and $250,000 (for taxpayers filing joint or surviving spouse) is taxed at 36% and income above $250,000 is taxed at 39.6%.

In addition, RRA '93 made permanent the limitation on itemized deductions and phase-out of personal and dependency exemptions. The itemized deduction limitation can add about 1% to the 39.6% rate and the personal and dependency exemptions are limited.

70. The higher tax brackets for other filing statuses are as follows:

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Income Bracket</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$115,000-$250,000</td>
<td>36%</td>
</tr>
<tr>
<td>Marital Separate</td>
<td>$70,000-$125,000</td>
<td>36%</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$127,500-$250,000</td>
<td>36%</td>
</tr>
<tr>
<td>Household</td>
<td>$250,000</td>
<td>39.6%</td>
</tr>
</tbody>
</table>

dependent exemption phase-out will continue to add about 0.5% per exemption to the marginal rate. Long-term capital gains will continue to be taxed at a maximum rate of 28%. With these changes, the maximum tax rate differential between ordinary and long-term capital gains has increased from 3% to 11.6%.

The new tax act also instituted a new top marginal rate for corporations of 35% applicable to corporations with taxable income in excess of $10 million.\footnote{72. I.R.C. § 11(b)(1)(D) as amended by Revenue Reconciliation Act of 1993.} A C corporation with taxable income in excess of $15 million must increase its tax liability by the lesser of 3% of taxable income over $15 million or $100,000.\footnote{73. Id. The additional charge for corporate income over $15 million phases out the benefit of the 34% rate, just as the benefit of the 15% and 25% rates is phased out when taxable income exceeds $100,000. See id.} For the first time since before TRA ’86, the top individual rates are now higher than the corporate rates. For small businesses, with income less than $10 million, there is now a 5.6% difference between the top marginal individual rate and the top effective corporate rate. While this may appear to make C corporation status more favorable for tax purposes than any of the pass-through forms (depending on distribution plans), each individual situation must be analyzed.

Regardless of the lower corporate rate, the corporate form still involves double taxation of income and gains. For example, if a corporation has $400,000 of taxable income from operations (assume no capital gains) with two 50% shareholders in the highest individual tax brackets, the corporate level tax will be $136,000 ($400,000 * 34%). If the after tax income of $264,000 is then subsequently distributed to the shareholders as dividends, each shareholder will incur $52,272 (50% * $264,000 * 39.6%) for a total individual tax of $104,544. The total income tax paid on the $400,000 is then $240,544 ($136,000 + 104,544), over 50%. Consider the same situation except that the business is a pass-through entity with two equal partners/shareholders/members in the highest individual tax brackets. The business will incur no entity level tax and the income will be taxed to the shareholders for a total of $158,400 ($400,000 * 39.6%).

Consider the same situation except that a portion of the businesses income is long-term capital gain. The taxes would be the same for the incorporated business because corporations are taxed on all income, whether capital or ordinary, based on the same rate schedule. However, if the income including the capital gains were passed out to the shareholders, there is the strong possibility that the total tax incurred would be even less than the $158,400 since the shareholders may be able to have the capital gain portion taxed at 28% rather than 39.6%.
Of course, there are options for the incorporated business in this example, such as retention of the income, but the penalty taxes mentioned previously must be considered and avoided. If the business is growing and thus reinvesting for capital expansion, retention of corporate earnings will probably be considered reasonable and not subject to penalties. The future plans and circumstances of both the business and the shareholders should be projected with as much accuracy as possible in determining which entity will provide the best tax results for the taxation of income.

A final consideration in the taxability of income should be the *alternative minimum tax* (AMT). Both corporations and individuals are subject to AMT which provides for an additional tax for taxpayers with certain types of otherwise allowable tax deductions and preferences. Examples of such deductions or preferences which might require a taxpayer to pay AMT are accelerated depreciation and statutory depletion over cost depletion.74

The corporate AMT rate is unchanged by RRA '93 at 20% with a $40,000 exemption (subject to phase-out); however, the individual AMT rate has been increased from a flat 24% rate to a tiered rate structure with the first $175,000 of alternative minimum taxable income (AMTI) taxed at 26% and any excess taxed at 28% (for married taxpayers filing separately, the 28% rate is applied to AMTI in excess of $87,500).76 In addition, the AMT exemptions (subject to phase-out) for individuals have been increased to $45,000 for joint returns, $33,750 for single taxpayers, and $22,500 for married taxpayers filing separately.77

Most AMT adjustments and preferences are the same for corporations and individuals. However, the corporate AMT rules provide for an additional adjustment to AMTI called the adjusted current earnings (ACE) adjustment which individuals are not required to make. One commentator has noted that the rationale behind the ACE adjustment for corporations is not absolutely clear, but "it appears to reflect Congress’s belief that profitable corporations should pay some tax, even if they have little or no regular taxable income." 78 On the other hand, corporations are allowed a minimum tax credit (MTC) for all AMT paid in post-1989 tax years, while individuals are allowed an MTC for prior AMT incurred as a result of certain adjustments and preferences, but not for the entire AMT previously paid.79

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74. I.R.C. § 56(a).
75. I.R.C. § 57(a).
77. I.R.C. § 55(d).
There is some indication that certain changes to the corporate AMT rules under RRA '93 may result in fewer corporations being subject to AMT. One such change is to the ACE adjustment. Prior to RRA '93, corporations were required to make adjustments to financial income for tax depreciation, AMT depreciation, and ACE depreciation. While the adjustment for tax depreciation generally resulted in accelerated deductions, the AMT depreciation adjustment decreased these deductions, and the ACE adjustment decreased them even further. Under RRA '93, the ACE depreciation adjustment is no longer applicable to property placed in service after 1993.

On the other hand, the changes to the individual AMT tax rates may result in more individuals being subject to the AMT. Individual taxpayers with a significant amount of capital gains and few AMT adjustments may find themselves subject to AMT since the maximum capital gains rate remains at 28% while the AMT rate above the exemption phase-out range is 35%.

When considering the taxability of income in making a choice of entity decision, one should consider, based on the type of business and the financial situations of the potential owners, whether AMT tax is likely to be incurred. For example, individuals involved in the oil & gas business are likely to be subject to AMT due to the number of preference items related to oil & gas production. The decision between a corporate form versus a flow-through entity may hinge more on AMT considerations than on regular income tax and thus should always be investigated in the initial analysis stage of the decision.

Deductibility of Losses and Basis

In any new business, there may be considerable losses incurred in the first few years before any income is generated. As such, the deductibility of losses is a crucial consideration in the choice of entity decision. The basis of a sole proprietor in his/her business is basically his adjusted basis in the assets devoted for use in the business. Sole proprietors can generally offset their income from other sources with losses from their business.

A risk with a sole proprietorship that is incurring losses is that the IRS will disallow the losses based on the "hobby loss rules." Generally, under IRC §183, an activity is presumed to be engaged in for profit if three or more of the taxable years in a period of five consecutive taxable years the deductions from the activity are greater than the gross income. In such a case, the net loss is not allowed for tax purposes. As the nickname indicates, these rules were established to prevent taxpayers from deducting losses from recreational and hobby-type activities as business losses.

80. Id.
The basis of a shareholder in his C corporation stock will be his basis upon formation of the corporation. As explained previously, if the corporation was formed in a §351 transaction, then the basis will be equal to the basis in the property transferred minus boot received plus any gain recognized on the transfer. If the corporation is otherwise formed in a taxable transaction, the shareholder’s basis will be the fair market value of property used to purchase the stock. Any subsequent contributions to capital will increase the shareholder’s basis and any distributions from a corporation without earnings and profits will decrease basis, but not below zero.

The corporation retains any losses incurred as net operating losses which can be carried back three years or forward fifteen years to offset corporate taxable income. The shareholders cannot use such losses to offset their other income. However, the sale of stock in a loss generating company may generate a loss for the shareholder. This loss will generally be a capital loss. This capital loss would offset any capital gain and ordinary income to the extent of $3,000 per tax year with an unlimited carryover.

Generally, any loans made from a shareholder to the corporation which become worthless will generate a short term capital loss as a nonbusiness bad debt (also subject to the $3,000 a year limitation). In rare circumstances, the loss may be characterized as a business bad debt and as such will be treated as an ordinary loss with no limitations on deductibility.

Finally, the shareholders stock in the corporation may become worthless. The general rule is that losses from worthless securities are capital losses; however, if the stock qualifies as IRC §1244 small business stock, the loss will be ordinary to the extent of $50,000 per year or $100,000 for a husband and wife filing a joint return. There are several requirements for stock to qualify as §1244 stock, but primarily, the corporation must not have received more than $1,000,000 of money and other property as a contribution to capital and as paid-in surplus for all of its issued stock. Stock of an S corporation does not qualify for §1244 treatment.

The calculations required to determine a shareholder’s basis in S corporation stock are much more intricate than that of C corporation stock due to the pass-through of all tax items to the shareholders. The initial basis for a

82. I.R.C. § 358.
83. I.R.C. § 172.
84. I.R.C. § 166(d)(1)(B).
85. I.R.C. §§ 165(a) & 166(d)(2); See also Whipple v. Commissioner, 373 U.S. 193 (1963); United States v. Generes, 405 U.S. 93 (1972).
86. I.R.C. § 165(g).
87. I.R.C. § 1244.
88. I.R.C. § 1244(c).
shareholder in his/her S corporation stock is calculated the same as for a C corporation. Thereafter, IRC §1367 provides a listing of all items which increase or decrease the shareholder’s basis. Basically, the basis is increased by all items of income and gain passed through to the shareholder and the excess of deductions for depletion over the basis of the property subject to depletion (if applicable). The shareholder’s basis is decreased, but not below zero, by non-taxable distributions, all items of deductions and losses passed through to the shareholder, any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and the amount of the shareholder’s deductions for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder.

A partner’s basis in his partnership interest is initially the amount of money and the adjusted basis of property contributed to the partnership plus the amount of any gain recognized by the partner at the time of contribution. Subsequently, the basis is increased by the partner’s share of taxable income and exempt income, and the excess of any deductions for depletion over the basis of property subject to depletion. The partner’s basis is decreased, but not below zero, by his share of losses and deductions of the partnership, expenses of the partnership not deductible in computing its taxable income and not properly chargeable to capital account, and the partner’s deduction for depletion with respect to oil and gas wells.

A partner and an S corporation shareholder calculate their basis in a similar manner with similar increases and decreases; however, there is one primary difference between the two. For purposes of deducting pass-through losses, a partner is allowed to include in his basis, his share of partnership liabilities. The partner’s share of partnership liabilities depends upon whether the loan is recourse or nonrecourse and upon the partner’s general or limited liability status in the partnership. There are detailed rules with regard to the allocation of liabilities provided by IRC §752. Generally, general partners share in recourse and nonrecourse liabilities, while limited partners share only in nonrecourse liabilities.

89. I.R.C. § 1367(a)(1).
90. I.R.C. § 1367(a)(2).
92. I.R.C. § 705(a)(1).
93. I.R.C. § 705(a)(2).
94. I.R.C. § 752.
95. The treatment of partnership liabilities depends upon whether the liabilities are subject to the 1988 or 1956 Treasury Regulations. The 1988 regulations generally apply to liabilities.
For purposes of loss deductions, both S corporation shareholders and partners can recognize losses to the extent of basis, but not below zero. They are both allowed to include in their basis any personal loans made to the entity. However, loans which are personally guaranteed can only increase a partner’s basis but not an S corporation shareholder’s. The difference in basis calculations can be a significant distinguishing feature between S corporations and partnerships. While the S corporation offers the benefit of limited liability for the shareholders when a partnership may or may not (depending on whether the partners are general or limited), the fact remains that for many small start-up businesses, lenders will require the owners to personally guarantee loans made to the business. If a partnership is used, the partners receive a benefit for these guarantees in the early loss years of a new business, whereas S corporation shareholders do not. Also, the owners of any business which will rely on significant debt financing will receive greater loss deduction potential in the partnership form versus the S corporation form. If the owners want to use S corporation status for other reasons, this limitation might be overcome by the shareholders borrowing money directly and then making personal loans to the S corporation.

The losses and certain deductions of partnerships and S corporations are passed out to the shareholders in their original character (i.e. capital, ordinary, investment interest expense). These losses are subject to the basis limitations discussed above, as well as at-risk and passive activity limitations determined at the individual level. Certain separately stated deductions may also be subject to limitations at the individual level. For example, investment interest expense will only be deductible to the extent of the individual’s investment income.

Under IRC §465(b) a taxpayer is considered to be at-risk only to the extent of (1) the money and adjusted basis of property contributed to the activity; and (2) amounts borrowed by the organization, if he is personally liable for the repayment of the loan. Any deduction not allowed due to the at-risk rules may be carried over for possible deduction in subsequent years under IRC §465(a)(2).

Finally, S corporation shareholder and partner losses may be subject to the passive activity limitations. Any loss which is considered to be from a passive activity can only be used to offset income derived from other passive activities. In general, a passive activity is any activity including the conduct

96. I.R.C. §§ 1366(d)(1)(B) and 752.
97. I.R.C. § 163(d).
98. I.R.C. § 469.
CHOICE OF BUSINESS TAX ENTITY AFTER THE 1993 TAX ACT

of a trade or business in which the taxpayer does not materially participate.\textsuperscript{99} There are in-depth rules regarding the qualification for material participation, but generally material participation means involvement in the operations of the activity on a basis which is regular, continuous, and substantial.\textsuperscript{100} A limited partnership interest is almost always considered an interest with respect to which a taxpayer does not materially participate.\textsuperscript{101} The corporate form is generally not subject to the passive activity rules.\textsuperscript{102}

Prior to RRA '93, real estate activities were statutorily deemed to be passive activities.\textsuperscript{103} For tax years beginning after 1993, real estate activities of eligible professionals may be non-passive. Eligibility is established if (1) more than one-half of the personal services performed during the year are in real property trades or businesses in which the taxpayer materially participates, and (2) more than 750 hours of service are performed in those businesses during the year.\textsuperscript{104} In addition, the taxpayer must be a material participant in the rental activity.

The passive loss limitations may be a significant factor in the decision between the corporate or pass-through form. While it may appear more favorable to choose a pass-through entity so that losses in the start-up years of the business can be deducted directly by the owners, this benefit can be completely nullified by the passive activity rules. This is particularly so in the case of a limited partnership, where all losses from limited partnership interests will be considered passive. Again, the individual situations of the potential owners must be considered since individuals with considerable amounts of passive income from other sources will be able to use passive losses to offset such income.

Special Allocations

The issue of special allocations is not applicable to sole proprietorships or C corporations. In the case of a sole proprietor, there are no allocations because there is only one owner. In the case of the C corporation, no taxable items are passed out to the individual shareholders and thus no special allocations are applicable. However, potential owners may be interested in obtaining disproportionate allocations of certain tax items. For example, an

\begin{itemize}
  \item \textsuperscript{99} I.R.C. § 469(c).
  \item \textsuperscript{100} I.R.C. § 469(h).
  \item \textsuperscript{101} I.R.C. § 469(h)(2).
  \item \textsuperscript{102} But see special rules for close corporations and personal service corporations under I.R.C. § 469.
  \item \textsuperscript{103} I.R.C. § 469(c)(2) (prior to Revenue Reconciliation Act of 1993).
  \item \textsuperscript{104} I.R.C. § 469(c)(7) (as added by Revenue Reconciliation Act of 1993).
\end{itemize}
owner making a major capital investment in a business may want to receive most of the benefits of certain tax deductions such as depreciation.

The S corporation does not provide this flexibility. All tax items are required to be distributed on a pro rata basis to all shareholders.\(^{105}\) The only entity form which does provide some flexibility with regards to special allocations is the partnership (or LLC) form. Special allocations of tax items are allowed in partnerships, but there are significant restrictions. Generally, a partner’s distributive share of tax items are determined by the partnership agreement,\(^{106}\) which can specify any type of special allocation. However, if the partnership agreement does not provide as to the partner’s distributive share of tax items or if the allocations under the agreement do not have “substantial economic effect,” the items will be allocated based on the partner’s interest in the partnership.\(^{107}\)

Prior to the Tax Reform Act of 1976 (TRA ’76), partnerships were able to shift significant amounts of income and deductions between partners using special allocations without limit. The final partnership Treasury Regulations implementing TRA ’76 placed considerable limitations on such allocations. The rules with regards to the determination of “substantial economic effect” and a “partner’s interest in the partnership” are quite complex,\(^{108}\) but they basically provide that a special allocation must substantially effect the actual dollar amounts to be received by the partners from the partnership independent of tax consequences in order to be recognized for tax purposes.

Under these rules, it is quite difficult to make disproportionate allocations in a partnership, but still possible. Due to the complexity and difficulty with conforming to the partnership special allocation rules, it may be that the availability of special allocations will not be a significant tax consideration in the choice of entity decision.

**Distributions**

Distributions from a sole proprietorship are not taxable to the proprietor since all of the businesses net income and gains are taxed directly to the proprietor. Distributions from a C corporation, however, are taxable to the shareholders as dividends to the extent the corporation has earnings and profits.\(^{109}\) The calculation of corporate earnings and profits is similar to the con-

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106. I.R.C. § 704(a).
107. I.R.C. § 704(b).
cept of economic income; it concentrates on dividend paying ability. For example, tax-exempt income is included and federal income taxes are deducted.  

Some dividends made as redemptions or in liquidation result in capital gain or loss to the shareholder rather than ordinary dividend income (See Retirement or Death of Owner section below). If the shareholder is a corporation, some of the dividends may be eligible for non-recognition under the dividends-received deduction.

If the corporation distributes appreciated property to the shareholders, the corporation will recognize a gain on the distribution to the extent the fair market value of the property exceeds the corporation’s adjusted basis in such property. Dividend distributions decrease the corporation’s earnings and profits by the amount of money distributed, the principal amount of debt obligations distributed, the adjusted basis of non-appreciated property and the fair market value of appreciated property distributed. C corporation dividend distributions do not affect the shareholders’ bases in their stock.

Generally, distributions to S corporations shareholders are not taxable since the taxable income and gains of the S corporation have been passed out and taxed at the shareholder level as earned. If the S corporation does not have any C corporation accumulated earnings and profits, then the distributions are tax-free to the shareholders to the extent of their basis in the stock. If the amount of distribution exceeds the stock basis, the excess is treated as return of capital. If the stock has been held for less than one year, the gain will be short-term capital gain, otherwise it will be long-term capital gain.

If the S corporation does have C corporation earnings and profits, the dividend distributions are tax-free and reduce the shareholder’s basis to the extent of previously taxed income and the accumulated adjustments account balance. An S corporation might have previously taxed income (PTI) if it was an S corporation prior to 1983. In general, the accumulated adjustments account (post-1982) represents the S corporation’s undistributed net income. Any portion of distributions which remain after the accumulated adjustments account and PTI has been reduced to zero is taxed as ordinary dividends to the extent of any remaining C corporation earnings and profits. Additional distributions reduce the stock basis to zero and are then treated as return of capital as previously described.

110. See I.R.C. § 312.
112. I.R.C. § 311(a) & (b).
113. I.R.C. § 312.
114. I.R.C. § 1368(b).
115. I.R.C. § 1368(c).
If appreciated property is distributed by an S corporation, gain is recognized the same as for the C corporation. However, the gain is taxed to the shareholders under the pass-through rules which also increases the shareholder’s basis in the stock.

If all of the S corporation shareholders so elect, dividends may be made first out of earnings and profits and subject to tax rather than out of the accumulated adjustments account.\(^\text{116}\) It may be desirable to do this in order to avoid the assessment of a corporate level tax or an inadvertent termination due to excess passive income.

Similar to an S corporation, partnership distributions are made tax-free. Gain is only recognized if cash distributed exceeds the partner’s basis in the partnership.\(^\text{117}\) Gain or loss may also be recognized in non-pro rata distributions which changes the partner’s relative interest in certain ordinary income assets. Basically, there are special rules which prevent a partner from converting certain ordinary income assets into capital gain assets through the use of partnership distributions.\(^\text{118}\)

Generally, partnership property distributions do not result in recognition of gain or loss; however, there are special rules for property which was appreciated at the time of contribution to the partnership. The 1992 Energy Act added I.R.C. §737 which requires a partner that contributes appreciated property to a partnership to recognize a portion or all of the precontribution gain upon a subsequent distribution of any property (not limited to the appreciated property) to that partner.\(^\text{119}\) This prevents a partner from engaging in a tax-free sale or exchange of appreciated property.

**Accounting Matters**

As far as the accounting method to be used, cash versus accrual, the accrual method must be maintained for inventory of any business form. The sole proprietorship may use either the cash or accrual method. The taxable year of a sole proprietorship is the same as that of the individual proprietor.

**C corporations** with gross receipts of $5 million or more in the three prior tax years and **partnerships with C corporation partners** must use the accrual method.\(^\text{120}\) Otherwise, a C corporation can use the cash or accrual

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117. I.R.C. § 731(a).
118. See I.R.C. § 751 (for general statute governing unrealized receivables and inventory).
120. I.R.C. § 448.
method as elected. The C corporation is allowed to select any taxable year on its first federal income tax return that is consistent with the first accounting period. The taxable year is required to be the same as the corporation’s annual accounting period (a twelve month period). A taxable year that ends on the same day of the week in each year (called a 52-53 week year) is also available.

A partnership or LLC can use the cash or accrual method as elected. Under IRC §706, a partnership must generally adopt the same taxable year as the partners owning a majority interest in the partnership profits and capital. If a majority of such partners do not have the same taxable year, the partnership is required to adopt the same taxable year as all of its principal partners. If all of the principal partners do not have the same taxable year, the partnership must adopt the calendar year, unless another year is prescribed by the Secretary of the Treasury. Some tax planning may be involved in establishing the tax year since deferral of income can result to the extent that the partner’s and the partnership’s taxable years are not the same.

An S corporation can use the cash or accrual method and does not have the gross income limitation of the C corporation. The S corporation has less flexibility than the C corporation in its selection of a tax year in that it is required to use a calendar taxable year or a year-end with a deferral period of less than three months, unless it is established to the satisfaction of the IRS that a business purpose exists for having a different taxable year.

Sale of Interests

When a business entity is formed, the potential owners should not only consider the tax effects of forming and operating the business, but also the results of terminating certain relationships within the entity through the sale of ownership interests, retirement of an owner, or a complete termination or reorganization of the entity itself. This and the following sections will address these issues.

The primary issue in the sale of an ownership interest is how the gain or loss on the sale is determined, and whether the gain or loss will be considered capital or ordinary. It is generally desirable to obtain long-term capital gains rather than ordinary or short-term capital gains, since the long-term capital gains

121. I.R.C. § 441(b) & (c).
122. I.R.C. § 441(f)(1).
123. But see Temp. Treas. Reg. § 1.706-1T (1993) (requiring that the taxable year used must result in the “least aggregate deferral of income”).
gains are taxed only at a maximum of 28% for individuals. As previously mentioned, this has become a much more crucial planning consideration under RRA '93 since the difference between the top individual rate and the maximum long-term capital gain rate is now 11.6%. If losses are anticipated, it is more beneficial to have ordinary losses rather than capital losses since capital losses are limited to $3,000 per year for individuals.

The sole proprietorship cannot actually sell interests in the business. Rather, each business asset is considered to be sold separately. Therefore, the nature of each asset determines the ordinary or capital treatment of the resulting gain or loss. It may be that the business is sold in bulk and, if so, the purchase price should be allocated to each asset and separate gains and losses then calculated.

When a shareholder in a C corporation sells his or her interest, there is generally a long-term capital gain or loss based on the difference between the selling price and the shareholder's basis in the stock. There are some exceptions to the capital treatment of such stock sales. First, the stock must be held greater than one year to receive long-term status.125 Second, if the shareholder is a dealer in securities, then the gain or loss will be ordinary, as the stock will be considered to be a type of inventory.126 Finally, there are special limitations to the capital gain treatment for stock sales of collapsible corporations. IRC §341 provides the rules regarding collapsible corporations, but generally, a collapsible corporation is a corporation that is designed to convert ordinary income to capital gains through liquidation or early sale of stock.

RRA '93 has introduced an incentive for noncorporate taxpayers to invest in "small business stock." Specifically, individuals who own qualified small business stock for at least five years can exclude up to 50%127 of the capital gain on disposition.128 The stock must be originally issued after 1992 and must be acquired in exchange for money, property other than stock, or as compensation for services. The new rule provides that a qualifying small business is a C corporation with less than $50 million in aggregate capital as of the date that the stock is issued. The corporation also must be engaged in the active conduct of a trade or business for substantially the entire holding period.

The sale of S corporation stock is treated in the same manner as for C corporation stock: the gain or loss will generally be long-term capital gain. The selling shareholder will be allocated his or her pro rata share of tax items

125. I.R.C. § 1223.
126. I.R.C. § 1236.
127. There are certain dollar amount limitations on this exclusion. I.R.C. § 1202(b)(1).
for the year through the date of sale.

The sale of a partnership interest will also generally result in a long-term capital gain or loss if the one year holding period is met. However, if the partnership has unrealized receivables or "substantially" appreciated inventory items, the selling partner is treated as having sold his proportionate share in the partnership assets. As a result, a proportionate share of the sales proceeds is allocated to these assets and the gain recognized is ordinary. Any remaining gain or loss will be treated as capital.\(^{129}\)

Given this exception, the sale of a partnership interest is more likely to result in ordinary income than the sale of corporate stock. In fact, the sale could result in the worst possible scenario in which a partner is required to recognize ordinary gain due to unrealized receivables and appreciated inventory and a capital loss if the transaction results in an overall loss.

**Retirement or Death of Owner**

In the case of the retirement of a sole proprietor, the assets of the business will generally be sold as described above. If the sole proprietor dies, the business assets will pass under the terms of the proprietor’s will or under the applicable intestacy statute. The proprietor’s assets will receive a stepped-up basis under §1014 to their date of death value.

In the event of the retirement or death of a corporate shareholder, the retiring shareholder or the estate will generally sell the stock or have the stock redeemed by the corporation. In a closely-held business, there will generally not be a ready market for the stock; therefore, it is advisable to have a buy-sell agreement among the shareholders and/or between the shareholders and the corporation. This type of agreement will require the remaining shareholders to purchase the retiring or deceased shareholder’s shares or for the corporation to redeem such shares. The shareholders and/or corporation can purchase certain life insurance contracts to use for the purchase of such stock.

A buy-sell agreement will aid in determining the value of the stock for estate tax purposes. Also, the buy-sell agreement can protect the remaining shareholders from having unwanted new shareholders purchase or inherit the stock without first having the opportunity to buy it themselves. Finally, the buy-sell agreement can give an estate more liquidity and flexibility.

If the stock is sold through a buy-sell agreement or otherwise, the sale will be treated the same as discussed above, i.e. capital gain or loss treatment will generally prevail. If the corporation redeems the stock, the redemption must meet certain requirements in order for the transaction to be considered

\(^{129}\) I.R.C. §751.
a capital transaction allowing basis offset on the part of the shareholder or estate versus a dividend distribution. In either case, the corporation does not receive a deduction.

The tests for redemption qualification are primarily mechanical and are usually easy to meet in the case of a retirement or death of a shareholder. Generally, the redemption must either completely terminate the shareholder’s interest in the corporation, be substantially disproportionate with respect to the shareholder, or not be essentially equivalent to a dividend. Also, in the case of the death of a shareholder, IRC §303 provides that a redemption of stock after the death of a shareholder to pay the shareholder’s funeral and administrative expenses, as well as death taxes, will qualify for capital gains treatment even if it might otherwise be taxable as a dividend.

Generally, the effects of retirement or death of an S corporation shareholder are the same as for C corporations. It should be remembered however, that there are strict limitations as to who can be a qualified shareholder. The terms of a S corporation shareholder’s will should ensure that the S stock will not pass to any unqualified shareholders, particularly if the stock might end up in a trust, or that such passing could cause the thirty-five shareholder limit to be exceeded. In the case of retirement, the S corporation shareholders may also want to enter into a buy-sell agreement or at least have an agreement which prohibits any shareholder from selling his or her stock to an unqualified shareholder.

The treatment of a death or retirement of a partner in a partnership offers the most tax flexibility of all the forms. The death or retirement of a partner can result in the liquidation of the entire partnership (see Liquidation, Dissolution, or Termination section below). However, there are two other options for partners: sale, or liquidation of the partnership interest. The sale of a partnership interest, whether to another partner or to a third party, is treated the same as discussed in the previous section. The liquidation of a partnership interest provides some planning opportunities.

In the case of a complete liquidation of a partner’s interest, IRC §736 provides that payments from the partnership to the partner or estate are divided into two categories called §736(a) and §736(b) payments. IRC §736(b) payments represent payments made in respect of the partner’s interest in the partnership, except for the partner’s share of unrealized receivables of the partnership and partnership goodwill. These payments are treated as distributions for the entire partnership interest, and thus, any difference between the partner’s basis in his partnership interest (excluding that portion attributable

131. I.R.C. § 302(b)(1)-(3).
to the unrealized receivables of the partnership and partnership goodwill) and the payments is generally accorded capital gain or loss treatment. These payments are not deductible by the partnership.

IRC §736(a) payments reflect payments made to a retiring or deceased partner’s estate for unrealized receivables, goodwill, and any other payments not made for the partner’s interest in the partnership. All such payments are treated as ordinary income to the partner less the partner’s share of unrealized receivables and goodwill. If the payments are determined with regard to the partnership’s income, they are treated as a distributive share of partnership income, and the distributive share of all remaining partners’ income is thereby reduced. If the payment is not determined with regard to the partnership’s income, they are treated as a guaranteed payment with similar results.

There are some planning opportunities with regard to partnership liquidating distributions since there is the opportunity for the remaining partners to reduce their share of partnership income, and for the liquidating partner to have ordinary or capital gain treatment. For example, the partnership agreement can provide for goodwill payments upon the retirement or death of a partner to be treated as payments made in respect of the partner’s interest in partnership property [$736(b)]]. There are conflicting interests between the continuing partners and the liquidating partner, since the continuing partners will want goodwill payments to be treated as §736(a) payments which will reduce their share of ordinary income. On the other hand, the liquidating partner will want as much of the total payments, including payments for goodwill, to be classified as §736(b) payments in order to receive capital gain treatment. Future allocations of liquidating payments should be specified in the partnership agreement when the entity is formed.

Liquidation, Dissolution, or Termination

A sole proprietorship is not necessarily liquidated or dissolved, rather it can be terminated when the business assets are sold. The treatment for the sale of sole proprietor assets is discussed above.

In the case of both C corporations and S corporations, gains and most losses on assets distributed by a liquidating corporation are to be recognized as if those assets had been sold to the distributee shareholders at their fair market value. The shareholders receive capital gain or loss treatment for the difference between their adjusted stock basis and the fair market value of the liquidating distributions received.

A C corporation is terminated upon its liquidation and dissolution. However, an S corporation can also be terminated by purposely or inadvertently not meeting one of the specified qualifications for S corporation status. Events which can cause an S status termination include (1) exceeding the maximum allowable number of shareholders, (2) transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien, (3) the creation of a class of stock other than the voting and nonvoting common stock allowed, and (4) the acquisition of a subsidiary. The S corporation may also be terminated in the case of excess passive income as previously discussed.

If a terminating event occurs, the day of the event will be treated as the last day of the S corporation short tax year. The following day will be the first day of a C corporation tax year. There are various options for allocating the S corporation tax items among the shareholders in the event of a termination of S status.

The S status may also be revoked by the consent of shareholders holding more than one-half of the corporation's voting stock. Once the S status has terminated, there is a transition period of one year, during which the balance of the accumulated adjustments account may be distributed without being taxed as C corporation dividends. If the IRS determines that a corporation's S election was inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation makes a timely correction of any condition which caused the termination.

Liquidating distributions of partnerships are only taxable to a partner to the extent distributed cash exceeds the adjusted basis of his partnership interest immediately before the distribution; no gain is recognized if cash is not distributed. A loss upon liquidating partnership distributions can only be recognized if cash, unrealized receivables, or inventory is distributed. Generally, the gain or loss recognized upon liquidation of the partnership will be capital, except to the extent it is attributable to unrealized receivables or substantially appreciated inventory.

A partnership may terminate upon the occurrence of two events: (1) if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (2) if within

133. I.R.C. § 1362(d)(2).
134. I.R.C. § 1362(e).
137. I.R.C. § 731(a)(2).
a twelve month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Generally, the latter event can be avoided by careful drafting of the partnership agreement. A technical termination should be avoided if the partners want to continue the business since a termination and continuation of the business as a new partnership can result in such undesirable tax consequences as the loss of tax elections, possible gain or loss recognition on a hypothetical distribution of assets, and basis adjustments.

State and Local Taxes

Before a final decision is made with regards to an entity choice, the potential imposition of state and local taxes should be considered. Some states tax all business income the same regardless of whether the form of business is sole proprietorship, corporation, etc. Some recognize pass-through entities and allow the individuals to be taxed on any income or gains while others tax pass-through entities as corporations imposing an entity level tax only.

In addition, most states impose a franchise tax on incorporated entities in addition to any income tax. In some states, this franchise tax may also be applied to limited liability companies, although it is unclear at this point how most states might treat these entities for such purposes.

If there is flexibility as to the state of incorporation and/or operation, it may be possible to avoid state income tax by incorporating in one of the few states that do not assess income taxes. Finally, it should always be remembered that a business can be taxed in any state in which it has nexus. If a business will be taxed in numerous states and S status or the partnership form is selected and recognized in those states, there will be considerably more tax returns to be filed as each shareholder/partner may be required to file in each state.

This is only a cursory view of the state and local tax issues which may arise in selecting the entity form. The effects of such taxes will depend greatly on the operations of the business and the states in question.

CONCLUSION

Choosing the legal and tax form for a new business entity is not an easy decision. A choice must be made between the sole proprietorship, the general or limited partnership, the corporation (C corporation or S corporation), and

the limited liability company. This article outlines some of the major tax and non-tax considerations which should be addressed before such a decision is made.

The primary non-tax factors include separate legal entity status, expense and formality of organization, management structure, continuity of existence, ease of financing, transferability of interest, and limited liability. The tax considerations include the tax consequences of the formation of the entity and subsequent contributions; entity income and losses; special allocations to owners; distributions and sales of interests; retirement or death of owners; liquidation, dissolution, or termination of the entity; state and local taxation; and various accounting matters.

Once an entity form has been chosen, it is important to follow the legal guidelines in order to obtain and preserve the desired status for legal and tax purposes. This will be best accomplished through the counsel of competent legal and tax advisors.

It is important to remember that the initial choice of entity form can provide great advantages or disadvantages for the future of the business. If it is determined that the initial decision was not the best or if circumstances have changed in such a way as to yield the initial decision disadvantageous, the entity can be converted. However, this can be a very costly process. In order to avoid such costly conversions, careful consideration should be given to both the current and possible future needs and desires of the business and its owners. The time and money spent on this decision will be one of the most important investments made by the future owners.
### APPENDIX A: CHOICE OF BUSINESS TAX ENTITY AFTER THE 1993 TAX ACT

**A comparison of the tax and non-tax attributes**

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Sole Proprietorship</th>
<th>C Corporation</th>
<th>S Corporation</th>
<th>Partnerships</th>
<th>Limited Liability Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Special Allocations</strong></td>
<td>Not Applicable</td>
<td>Not Applicable</td>
<td>Not available; all locations must be made prorata.</td>
<td>Special allocations are available, if they have substantial economic effect.</td>
<td>Same as Partnerships.</td>
</tr>
<tr>
<td><strong>Distributions</strong></td>
<td>Not taxable</td>
<td>Corporation recognizes gain on distribution of appreciated property, taxable to shareholders as dividends.</td>
<td>Distributions tax-free to the extent of accumulated S corp. income; thereafter, taxable to the extent of C corp earnings &amp; profits, tax-free to the extent of basis, remainder is capital gain.</td>
<td>Partners taxed only on cash distributions in excess of partner's basis in his partnership interest. Generally, such distributions treated as capital gains.</td>
<td>Same as Partnerships.</td>
</tr>
<tr>
<td><strong>Accounting Matters</strong></td>
<td>Generally allowed to use cash or accrual method of accounting; Tax year must be same as owner.</td>
<td>Must use accrual method unless annual gross receipts are less than $5 million; Generally free to adopt any tax year end.</td>
<td>Can use cash or accrual; no gross receipts limitation. Generally required to use a calendar tax year.</td>
<td>Generally can use cash or accrual unless it has a corporate partner; generally must use tax year which provides least amount of deferred income to partners.</td>
<td>Same as Partnerships.</td>
</tr>
<tr>
<td><strong>Sale of interests</strong></td>
<td>Cannot sell interests in business; must sell individual business assets.</td>
<td>Generally, long-term capital gain or loss; 50% of capital gain can be excluded upon the sale of qualified small business stock; ordinary loss may be available for qualified Section 1244 stock.</td>
<td>Generally, long-term capital gain or loss.</td>
<td>Generally, long-term capital gain or loss; if partnership has unrealized receivables or substantially appreciated inventory, a portion of the gain or loss will be ordinary.</td>
<td>Same as Partnerships.</td>
</tr>
<tr>
<td><strong>Retirement of Death of Owner</strong></td>
<td>Assets will be sold upon retirement; upon proprietor's death assets will pass into the estate and receive stepped-up basis.</td>
<td>No effect to the entity; can have buy-sell agreement among shareholders or agreement for corporate redemption; capital gain or loss upon redemption to the shareholder.</td>
<td>Same as C corporation.</td>
<td>Partner's interest can be sold or liquidated; if liquidated there is some flexibility with regards to structuring the transaction to produce capital and/or ordinary gains/losses; also partnership may receive some deductions upon liquidating a partner's interest.</td>
<td>Same as Partnerships.</td>
</tr>
<tr>
<td><strong>Liquidation, Dissolution, or Termination</strong></td>
<td>Terminated when business assets are sold.</td>
<td>Liquidating distributions treated as if the corporate assets had been sold to the shareholders.</td>
<td>Same as C corporation except can be terminated if qualifications for S status are violated, then reverts to C corporation status.</td>
<td>Liquidating distributions only taxable to the extent distributed cash exceeds partner's adjusted basis in partnership; loss can only be recognized if cash, unrealized receivables, or inventory is distributed.</td>
<td>Same as Partnerships.</td>
</tr>
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