

Choosing The Right Form Of Entity In A World Of Changing Tax Rates, Sunset Provisions And Globalization

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I. PRIMARY CONSIDERATIONS IN CHOOSING FORM OF ENTITY

- A. Limited Liability
- B. Tax Consequences
- C. Flexibility
- D. Exit Strategy

II. DIFFERENT TYPES OF ENTITIES

- A. Sole proprietorships
- B. General partnership
- C. Limited Partnerships
- D. Limited Liability Limited Partnerships
- E. Limited Liability Companies
- F. Regular “C” Corporations
- G. “S” Corporations
- H. Trusts
- I. Specialized Entities: Publicly Traded Partnerships, Real Estate Investments Trusts (REIT), Regulated Investment Companies (RIC), Real Estate Mortgage Investment Conduit (REMIC), Financial Asset Securitization Investment Trust (FASIT), Insurance Companies, Non-profit Corporations, Cooperatives.¹

III. FEDERAL TAX CLASSIFICATION OF ENTITIES

- A. Check-The-Box Regulations Adopted in 1996. T.D. 8697, 61 Fed. Reg. 66584 (12/18/96), adding new Treas. Reg. § § 301.7701-1 through 301.7701-3.
- B. Unincorporated associations can elect to be treated as (i) associations taxable as corporations, or (ii) partnerships.
- C. Corporations formed under state law, certain foreign entities resembling U.S. corporations, entities taxable as corporations under the Internal Revenue Code and trusts are excluded from the check-the box regulations. Treas. Reg. §§ 301.7701-2(b) and 301.7701-3(a).
 - 1. Organization that lacks associates and an objective to carry on business for profit must be classified as a trust. Treas. Reg. § 301.7701-4.

¹ The remainder of this outline focuses solely on the mostly commonly used formed of entities, namely, sole proprietorships, general partnerships, limited partnerships, limited liability partnerships, limited liability companies, and “C” and “S” corporations. This is a general discussion only of the factors that should be evaluated in determining choice of entity.

2. Treas. Reg. 301.7701-2(b)(8)(i) lists over 75 foreign entities that will be automatically treated as corporations (“per se corporations”).

D. Default rules apply if entity fails to make specific election:

1. *Domestic Entities*

- a. Noncorporate domestic organizations with more than one member are taxable as partnerships. Treas. Reg. 301.7701-3(b)(1).
- b. Single member domestic entities are disregarded for federal tax purposes. Treas. Reg. 301.7701-3(b)(1).
- c. If a husband and wife own the entity as community property, the IRS will permit them to treat entity as either a partnership or disregarded entity. Rev. Proc. 2002-69, 2002-45 IRB 831.

2. *Foreign entities*

- a. Noncorporate foreign entities with two or more members where at least one member does not have limited liability are classified as partnerships. Treas. Reg. § 301.7701-3(b)(2)(i).
- b. Foreign entities where all members have limited liability are classified as associations. Treas. Reg. § 301.7701-3(b)(2)(ii).
- c. Foreign entities are disregarded if it has a single owner that does not have limited liability. Treas. Reg. 301.7701-3(b)(2)(i).
- d. Recently issued regulations allow some foreign business entities that were treated as partnerships before the date on which the check-the-box regulations were initially proposed and that would otherwise be classified as “per se corporations” under Treas. Reg. 301.7701-2(b)(8)(i) to continue to be classified as partnerships if certain conditions are satisfied. T.D. 9093, 68 Fed. Reg. 60296 (Oct. 22, 2003).

IV. CORPORATE CHARACTERISTICS OF ENTITIES

A. *Sole Proprietorship*

1. Limited Liability: A sole proprietorship has unlimited liability.
2. Formation: No separate entity is created.

B. *General Partnership*

1. Limited Liability: All general partners have unlimited liability for partnership indebtedness and creditors can collect against personal assets of general partners.
2. Formation: A separate entity is created by agreement. Oral partnerships are generally recognized under state law but written partnership agreements are recommended.
3. Most states have enacted the Uniform Partnership Act. *See e.g.*, California Corporations Code §§ 16100-16962.

C. *Limited Partnerships*

1. Limited partnerships are formed by two or more persons under the limited partnership laws of a state.
2. A limited partnership must have one general partner who has unlimited liability and one limited partner. Corporations are frequently used as the general partner in order to limit the personal liability of the individual investors.
3. Most states have enacted the Revised Uniform Limited Partnership Act which requires that a certificate of limited partnership be filed in the office of the Secretary of State in the state of formation for the limited partnership to be validly formed. *See e.g.*, California Corporations Code §§ 15611-15723.
4. A written partnership agreement is advisable to provide for the respective rights and obligations of the partners.

D. *Limited Liability Partnerships (“LLPs”)*

1. A limited liability partnership is provided in most states for professional practices such as attorneys, accountants and physicians. *See e.g.*, California Corporations Code §§ 16951-16962.

2. An LLP follows the basic structure of a general partnership but provides for partial limited liability of its partners. Under most state laws, partners in LLPs remain personally liable for their own acts of wrongdoing and those they directly supervise, but their personal assets are protected from claims related to the wrongful acts of other partners.

E. *Limited Liability Companies (“LLCs”)*

1. An LLC is a hybrid entity that generally provides protection against creditor claims to the same extent as a corporation but is typically treated as a partnership for federal and state tax purposes. Its owners are typically referred to as members.
2. LLCs have the benefit of combining the corporate liability protection with the flexibility for tax planning provided by partnerships.
3. State laws generally require that articles of formation or organization be filed with the office of the Secretary of State in the state of formation for valid organization of the LLC. *See e.g.*, California Corporations Code §§ 17000-17655.
4. A written operating agreement is advisable to govern the respective rights and obligations of the members of the LLC.

F. *“C” Corporations*

1. A corporation is formed by state law through compliance with the applicable state statute. Articles of formation or incorporation must be filed with the office of the Secretary of State in the state of formation. *See e.g.*, California Corporations Code §§ 100-8910.
2. A corporation is its own distinct taxable entity for tax purposes. Profits paid out to its shareholders are subject to double taxation when distributed out as dividends.

G. *“S” Corporations*

1. An S corporation is a special kind of corporation for tax purposes.
2. An “S” corporation is formed under the usual state law corporation rules for organizing corporations.
3. To become an S corporation, the shareholders must make an election, which is required to be filed with the IRS within two-and-a-half (2 ½) months after the S corporation begins to do business. IRC § 1362(b)(2).

4. S corporations are pass through entities for tax purposes but are subject to many more restrictions than are partnerships or LLCs.

H. *Restrictions on Equity Holders*

1. S corporations may not have more than 75 shareholders. IRC § 1361(b)(1)(A). Only certain individuals and entities are eligible shareholders of an S corporation:
 - a. Individuals who are citizens or U.S. residents. IRC § 1361(b)(1)(C).
 - b. The following types of trusts:
 - (i) Grantor trusts. IRC § 1361(c)(2)(A)(i).
 - (ii) Trust which was a grantor trust immediately before the death of the deemed owner, but only for a two-year period beginning on the date of death of the deemed owner. IRC § 1361(c)(2)(A)(ii).
 - (iii) A trust which has stock transferred to it pursuant to the terms of a will, but only for a two-year period beginning on the date on which that stock is transferred to the trust. IRC § 1361(c)(2)(A)(iii).
 - (iv) A voting trust. IRC § 1361(c)(2)(A)(iv).
 - (v) A “qualified Subchapter S” trust which is defined as a trust the terms of which require that the trust have only one current income beneficiary, corpus distributed during the life of the current income beneficiary can be distributed only to that beneficiary, the income interest of the current income beneficiary terminates on the earlier of such beneficiary’s death or termination of the trust, upon termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to such beneficiary; and all of the income is distributed or required to be distributed currently to one citizen or US resident. IRC § 1361(d)(1).
 - (vi) An “electing small business trust”: all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders or certain charitable organizations and any interest in the trust must have been acquired by gift or inheritance. IRC § 1361(c)(2)(A)(v).

2. Partnerships, LLCs and “C” corporations are not subject to any restrictions about the number or type of partners/members, or shareholders they may have. A partnership may have so many partners that it becomes classified as a “publicly traded partnership” and, pursuant to IRC § 7704(b), taxable as a corporation rather than a partnership.

I. *Restrictions on Equity*

1. S corporations can have only one class of common stock. IRC § 1361(b)(1)(D).
 - a. S corporations can have both voting and non-voting common stock without running afoul of the one class of stock requirement. IRC § 1361(c)(4).
 - b. To avoid risk of debt being reclassified as stock, a safe harbor for debt is provided in IRC § 1361(c)(5).
2. General partnerships generally have only one class of partners.
3. Limited partnerships, LLCs and “C” corporations are not limited in the number of different types of limited partnership interests, membership interest, and stock that they can issue. They can each provide for multiple preferred classes of equity holders.

V. **FEDERAL INCOME TAX CONSIDERATIONS IN SELECTING FORM FOR ENTITY²**

A. *Taxation of Income*

1. Sole Proprietors report all income and expenses on Schedule C to their individual income tax returns.
2. Partnerships are not taxable on its income and expenses; income and expenses pass through to general partners in proportion to their allocable share of income and expenses. IRC §§ 701 and 702.
3. “C” corporations are taxable entities distinct from their shareholders and report income and expenses on their own income tax returns. IRC § 11.

² For federal income tax purposes, non-corporate domestic organizations with more than one member are treated as partnerships. If there is only one member, they are disregarded. Accordingly, the term “partnership” as used herein will also refer to limited liability companies with more than one member. A single member LLC, if owned by an individual, would be subject to tax in the same manner as a sole proprietorship; if owned by an entity will be subject to tax in the same manner as a division of the entity.

4. “S” corporations generally are not taxable on its income and expenses; income and expenses pass through to shareholders in proportion to their shareholdings. IRC § 1363(a). *But see*, IRC § 1374 (built-in gain), IRC § 1375 (passive investment income), and IRC § 1363(d) (LIFO recapture).

B. *Special Allocation of Income and Losses*

1. Sole Proprietorship: Special allocations not at issue since sole proprietor reports all income and expenses on his or her own income tax return.
2. Partnerships: Income and expenses allocated among partners in accordance with partnership agreement if agreement complies with “substantial economic effect” test of IRC § 704(b) and regulations thereunder; if substantial economic effect regulations not complied with, IRS can reallocate income and expenses in accordance with partner’s interest in the partnership. *See* Treas. Reg. § 1.704-1.
3. “C” corporations: C corporations are distinct taxable entities and income and expenses do not pass through to their shareholders so special allocations are not at issue.
4. “S” corporations: S corporations must allocate their income and expenses to their shareholders in proportion to their share ownership; special allocations are not permitted. IRC § 1361(b)(1)(D).

C. *Limitations on Tax Losses*

1. Sole Proprietorships: Losses are generally deductible by the individual owner. While individuals are subject to the at-risk rules of IRC § 465 and the passive loss rules of IRC § 469, these rules typically do not apply to the conduct of a business by an individual.
2. Partnerships: The ability of partners to deduct losses allocable to them are subject to certain limitations:
 - a. IRC §704(d) limits the amount of deductible loss to the partner’s adjusted basis in the partnership interest at the end of the partnership taxable year in which the loss occurred. Excess losses are held in suspense and are deductible in succeeding taxable years to the extent the partner’s adjusted basis in the partnership interest increases to an amount above zero.

- (i) Partners include their allocable share of partnership debt under the principles of IRC § 752 as part of their basis in their partnership interest for this purpose.
 - (ii) Suspended losses are personal to the partner and cannot be transferred when a partner sells his or her partnership interest, nor can it be deducted after the partner ceases to be a partner. *See Sennett vs. Comm'r*, 80 T.C. 825 (1983), *aff'd p.c.*, 85-1 USTC ¶ 9153 (9th Cir. 1985). A suspended loss can be used to offset gain realized on the sale or exchange of the partnership interest.
- b. IRC § 465 applies to individual partners and certain corporate partners and limits the amount of deductible loss to the amount “at risk” within the meaning of Section 465.
 - (i) To the extent a partner has a negative at-risk amount, IRC § 465(e) requires the partner to recapture an amount in income that will restore his or her at-risk amount to zero.
 - (ii) The at-risk rule is applied to the partner and not the partnership, so that the partner loses any suspended losses upon disposition of his or her partnership interest.
- c. IRC § 469 applies to partners who are individuals, trusts, estates, closely-held corporations and personal service corporations. It requires a partner to first determine whether his or her partnership interest is an active or passive activity; if passive, losses for the taxable year are generally allowed only to the extent that the taxpayer has aggregate income from passive activities. Losses exceeding passive are suspended and carried forward indefinitely and applied against passive income (if any) that is generated in future taxable years.
 - (i) IRC § 469(g)(1)(A) specifically provides that, upon disposition of a partnership interest by a partner, losses suspended under Section 469 may be deducted in full. This also applies when the partnership disposes of an activity which has generated suspended losses to the partner even though the partner does not dispose of his or her partnership interest.

3. “C” Corporations: losses remain at the corporate level and shareholders are not allocated losses.
 - a. A corporation is subject to the at-risk rules of IRC § 465 if it meets certain stock ownership rules applicable to personal holding companies.
 - b. A corporation is subject to the passive loss rules of IRC § 469 if it is a closely-held corporation or a personal service corporation. IRC § 469(a)(2)(b) and (c).
4. “S” Corporations: losses are passed through to their shareholders in proportion to their share ownership.
 - a. S corporation shareholders are subject to limitations on deduction of losses similar to those imposed on partners.
 - b. IRC § 1366 (d) limits the amount of deductible loss to the shareholder’s adjusted basis in their stock at the end of the partnership taxable year in which the loss occurred. Excess losses are held in suspense and are deductible in succeeding taxable years to the extent the shareholder’s adjusted basis in the partnership interest increases to an amount above zero.
 - (i) Shareholders include the amount of indebtedness owed to them by the corporation to determine basis in their stock for this purposes. IRC § 1366(d)(1)(B). They do not include any portion of corporate debt in their adjusted basis.
 - (ii) Special rules apply to the carryover of losses to periods following termination of the corporation’s status as an S corporation. IRC § 1366(d)(3).
 - (iii) Suspended losses are personal to the shareholder and cannot be transferred when the shareholder sells his or her stock nor can they be deducted after the shareholder ceases to be a shareholder. IRC § 1366(d)(2).
 - c. IRC § 465 limits the amount of deductible loss to individual shareholders to the amount “at-risk” within the meaning of Section 465.
 - (i) To the extent an S shareholder has a negative at-risk amount, IRC § 465(e) requires the partner to

recapture an amount in income that will restore his or her at-risk amount to zero. IRC § 1366(d)(3)(D)

- (ii) The at-risk rule is applied to the shareholder and not the corporation, so that the shareholder may not deduct any portion of the suspended losses upon disposition of his or her stock.
- d. IRC § 469 requires an individual shareholder to first determine whether his or her shareholder interest is an active or passive activity; if passive, losses for the taxable year are generally allowed only to the extent that the taxpayer has aggregate income from passive activities. Losses exceeding passive are suspended and carried forward indefinitely and applied against passive income (if any) that is generated in future taxable years.
- e. IRC § 469(g)(1)(A) specifically provides that, upon disposition of stock, losses suspended under Section 469 may be deducted in full. This also applies when the S corporation disposes of an activity which has generated suspended losses to the shareholder even though the shareholder does not dispose of his or her stock.
- f. If a shareholder has losses from an S corporation that are suspended under Section 469, the conversion of that corporation from S to C status is not considered a disposition that will trigger the suspended losses. Treas. Regs. § 1.469-1(f)(4)(iii).

D. *Contribution of Property on Formation*

- 1. Sole Proprietorship: No separate entity is formed
- 2. Partnerships: Under IRC § 721, cash and appreciated property can be contributed to partnerships on a tax-free basis.
 - a. This rule does not apply to contributions of property to partnerships treated as investment companies within the meaning of IRC § 351(e). IRC § 721(b).
 - b. Under IRC § 704, income, gain, loss, and deductions attributable to property contributed to a partnership by a partner must be allocated in a manner that takes into account any difference between the fair market value of the property and its adjusted basis at the time of the contribution. Application of Section 704(c) to depreciation

and other issues is complex and is designed to prevent assignment of income and deductions to other partners.

- c. Assumption of a debt owed by a partner to partnership and a partner's relief from liability is deemed to be a cash distribution to the partner in amount equal to debt relief and will result in taxable gain to the partner to the extent of the liability is shifted to other partners and the amount of debt relief exceeds the partner's adjusted basis in his or her partnership interest. IRC § 752(b).
3. "C" and "S" Corporations: Under IRC § 351, cash and appreciated property can be contributed to the corporation tax-free so long as contributing shareholders together own at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.
 - a. This rule does not apply to transfers of property to investment companies. IRC § 351(e).
 - b. If a contributing shareholder receives "boot" (including non-qualified preferred stock) in addition to stock, the shareholder is taxable on gain realized but not in excess of the amount of boot. IRC § 351(b).
 - c. IRC § 351(d) provides that stock issued for services is not considered to be issued for property.
 - d. If liabilities assumed by the corporation exceed the adjusted basis of the property contributed by the shareholder, the shareholder will recognize gain on the excess. IRC § 357(c).

E. *Basis of Owner's Interest in Entity*

1. Sole Proprietor: A sole proprietor owns interest in assets of business directly.
2. Partnership: A partner's basis in partnership interest equal to the amount of cash and the partner's adjusted basis of property contributed by partner to acquire the partnership. IRC § 722. A partner's share of partnership debt is treated as a contribution of cash to the partnership and increases his or her basis. IRC § 752(a).
 - a. A partner's basis in his or her partnership interest is increased by the partner's allocable share of partnership

income (including exempt income) and decreased by the partner's share of distributions of cash and by the adjusted basis of partnership property distributed (including deemed cash distributions from debt relief) and is further decreased by the partner's allocable share of losses (including nondeductible expenditures). IRC § 705.

3. Corporations: A shareholder's basis in his or her stock is equal to the amount of cash contributed and the shareholder's adjusted basis of the property contributed to the corporation, increased by any gain recognized on the transfer and decreased by any boot received. If a shareholder contributes property encumbered by a liability and the corporation assumes the liability or takes the property subject to the liability, the shareholder's stock basis is reduced by the entire liability. IRC § 358.

F. *Entity's Basis in Contributed Property*

1. Sole Proprietorship: A sole proprietorship is not a separate entity and has same basis as individual owner.
2. Partnership: A partnership's basis in property contributed to it by a partner is the adjusted basis in the property of the contributing partner increased by any gain realized under IRC § 721(b) by the partner on the contribution. IRC § 723.
3. Corporation: A corporation's basis in property contributed to it by a partner is the same as the transfer shareholder's basis increased by the amount of gain recognized to the shareholder as the transferee. IRC § 362(a).

G. *Taxable year of Entity*

1. Sole Proprietorship: Sole proprietorship has same taxable year as individual owner, which generally is a calendar year.
2. Partnership: Taxable year of partnership must be the "majority interest taxable year." IRC § 706(b)(1)(B)(i); Treas. Reg. 1.706-1(b)(2)(i)(A):
 - a. "Majority Interest taxable year" is taxable year of one or more partners holding more than 50% of partnership interests. IRC § 706(b)(4)(A)(i); Treas. Reg. 1.706-1(b)(4)
 - b. In absence of "majority interest taxable year, partnership taxable year must be taxable year of principal partners (a partner with a 5% or greater interest in partnership profits

or capital). IRC § 706(b)(1)(B)(ii); Treas. Reg. 1.706-1(b)(2)(i)(B)

- c. If there is neither a majority interest taxable year nor a common taxable year of all of the principal partners, then the partnership must report on a taxable year that produces the least aggregate deferral of income. IRC § 706(b)(1)(B)(iii); Treas. Reg. 1.706-1(b)(2)(i)(C).
- 3. “C” Corporation: C corporations can generally adopt a fiscal year. *IRC § 441(i)*
 - a. Personal service corporations are subject to certain limitations in adopting a fiscal year. *IRC § 441(i)*
 - 4. “S” Corporation: S corporations must adopt a “permitted year,” which is either (i) a calendar year, or (ii) any other year in which the corporation establishes a business purpose accepted by the IRS. *IRC § 1378(a)*.
 - a. An S corporation can in some cases elect a different taxable year. If this election is made, a payment is required to offset the benefit of deferral. *IRC § 444(a) and (c)(1)*.

H. *Entity Method of Accounting*

- 1. Sole Proprietorship: Sole proprietors are subject to the general rules of *IRC § 446* on the use of the cash and accrual methods of accounting. A sole proprietor may use one method of accounting for his or her trade or business and another for personal investments.
- 2. Partnerships: generally, a partnership may use any method of accounting that clearly reflects its income. *IRC § 446*.
 - a. However, if the partnership includes “C” corporations or tax shelters (as defined in *IRC § 448(d)(3)*), the partnership must use the accrual method of accounting. *IRC § 448(a)*.
 - b. Tax shelters, as defined in *IRC § 448(d)(3)*, must use the accrual method of accounting. *IRC § 448(a)*.
 - c. Exceptions are provided from the accrual accounting method requirement where the corporate partners are qualified personal service corporations (*IRC § 448(b)(2)*) or has gross receipts of no more than \$5 million (*IRC § 448(b)(3)*).

3. “C” Corporation: C corporations generally must use the accrual method of accounting. *IRC* § 448(a)(1). Exceptions are provided for (i) service entities with average gross receipts of not more than \$5 million, (ii) farming operations, and (iii) qualified personal service corporations. *IRC* § 448(b).
4. “S” Corporations: S corporations are not subject to the method of accounting limitations applicable to “C” corporations and are subject to the general rules for choosing a method of accounting.
 - a. If an S corporation is a “tax shelter” within the meaning of *IRC* § 448(d)(3), it will be required to report its income and expenses on the accrual method of accounting. *IRC* § 448(a).

I. *Alternative Minimum Tax*

1. Sole Proprietorship: Sole proprietor includes all tax preference items and adjustments related to the business in his or her own tax return. *IRC* § 55.
2. Partnerships: Partners report distributive share of partnership’s tax preference items and adjustments for alternative minimum tax purposes on their own tax returns. *IRC* § 55.
3. C Corporations: C corporations report tax preference items and adjustments for alternative minimum tax purposes. *IRC* § 55.
4. S Corporations: S corporation shareholders report distributive share of corporation’s tax preference items and adjustments for alternative minimum tax purposes on their own tax returns. *IRC* § 55.

J. *Filing Requirements*

1. Sole Proprietorships: Individual sole proprietorship reports income and expenses on Schedule C to Form 1040 and must file a separate Schedule C for each trade or business
2. Partnerships: Partnership files Form 1065 with Schedule K-1s and issues Schedule K-1s to partners for attachment to their returns
3. C Corporation: files Form 1120
4. S Corporation: files Form 1120S with Schedule K-1s and issues Schedule K-1s to shareholders for attachment to their tax returns

K. *Distributions of Cash or Appreciated Property*

1. Partnerships:

- a. No gain or loss is recognized to the partnership on distribution of cash or property (IRC § 731(b)), except in case where distribution disproportionately changes the partners' interest in Section 751 property. IRC § 751(b); Treas. Reg. 1.751-1(b)(1).
- b. A partner is taxable on cash and fair market value marketable securities distributed to the extent such amount exceeds partner's adjusted basis in partnership interest (IRC § 731(a)(1)); partner is not taxable on receipt of property and takes adjusted basis in property equal to partnership's basis. IRC § 732.

2. "C" Corporations:

- a. No deduction is allowable to the corporation for distributions of cash or property to shareholders; gain, but not loss, is recognized on the distribution of appreciated property as though it was sold for its fair market value. IRC § 311.
- b. Shareholder is taxable on the amount of cash and the fair market value of property distributed to shareholder to the extent of corporate earnings and profits as determined under IRC §312. For 2003 through 2009, a special rate of 15% applies to dividend distributions. Jobs Growth Tax Relief and Reconciliation Act of 2003, J.R. 2, §§ 301, 303. This special rate sunsets for taxable years ending after December 31, 2008.

3. "S" Corporations:

- a. Distribution of cash to shareholders has no tax consequences to the corporation; gain, but not loss, is recognized on the distribution of appreciated property as though it was sold for its fair market value (IRC § 311); this gain is passed through to the shareholders. IRC § 1366(a)(1)
- b. Distribution of cash or property is, first, tax free to the shareholder to the extent of the shareholder's "accumulated adjustment account" (generally, the portion of S corporation taxable income already taxed at the shareholder level); second, taxable as a dividend to the extent of the

corporation's "C" earnings and profits; and thereafter taxable to the extent the distribution exceeds the shareholder's adjusted basis in his or her stock. IRC § 1368(c).

L. *Redemptions of Equity Interests*

1. Partnership:

- a. No gain or loss is recognized to the partnership on distribution of cash or property (IRC § 731(b)), except in case where distribution disproportionately changes the partners' interest in Section 751 property. IRC § 751(b); Treas. Reg. 1.751-1(b)(1).
- b. A partner recognizes no taxable gain except to the extent cash and fair market value of marketable securities exceeds the partner's adjusted basis in partnership interest. Loss is not recognized to the partner except in cases where only cash, unrealized receivables, inventory is distributed to the partner in complete liquidation of the partner's interest. IRC § 731(a)(2).
- c. A partner's basis in property (other than money) distributed in complete liquidation of the partner's interest is equal to the partner's interest in the partnership less any money received. IRC § 732(b).

2. Corporations:

- a. A corporation recognizes no gain or loss on redemption of a shareholder's shares in the corporation, except that a corporation will recognize gain on the distribution of appreciated property in redemption of shareholder shares to the extent the fair market value of the property exceeds the corporation's adjusted basis. A corporation will not be entitled to deduct loss on the distribution of depreciated property. IRC § 311(b). This provision does not apply to the distribution of a corporate installment obligation and a corporation may redeem a shareholder's share on an installment basis free of tax. IRC § 311(b)(1).
- b. If the distribution qualifies as redemption under IRC § 302, the shareholder will realize gain or loss on the redemption equal to the difference between the shareholder's adjusted basis in the stock and the fair market value of the proceeds received from the corporation in redemption. IRC § 1001. If the stock is a capital asset in the hands of the

shareholder, the gain or loss will be a capital gain or loss and will be long-term if the shareholder has held the stock for at least one year. IRC §§ 1221, 1222. The shareholder will have a basis in property received pursuant to the redemption equal to the fair market value of the stock redeemed. IRC § 1012.

3. “S” Corporation

- a. The tax consequences to the corporation of a redemption of shares owned by a shareholder are governed by the same rules as with respect to C corporations discussed above. If the corporation recognizes gain on the distribution of appreciated property, the gain will be taxable to the shareholder under the general pass-through rules of “S” corporations.
- b. Redemption of “S” corporation shareholder stock present a few unique issues:
 - (i) The S shareholder is allocated his or her share of S corporation income or loss on a per-share, per-day basis (including the date of termination of the shareholder’s interest), unless all of the affected shareholders agree to a “closing of the books.” IRC § 1377.
 - (ii) There is no mechanism for tax-free distributions to a terminated shareholder.

M. *Liquidation of Entities*

1. Partnerships

- a. No gain or loss recognized to partnership on liquidation of the partnership. IRC § 731(b).
- b. Partners will recognize gain to the extent cash and marketable securities distribution to a partner exceeds the partner’s adjusted basis with his or her partnership interest. IRC § 731(a)(1) and (c). Loss is recognized by the partner only if partner is distributed solely cash, marketable securities, unrealized receivables and inventory and their aggregate fair market value is less than the partner’s adjusted basis in his or her partnership interest. IRC § 731(a)(2).

- c. Partnership rules provide that partnership is deemed terminated upon (1) cessation of all business activities or discontinuing operations, or (2) transfer of more than 50% of partnership interest in profits and capital within a 12-month period. IRC § 708(b)(1).

2. Corporations

- a. “C” and “S” corporations are deemed to have sold their assets on liquidation of the corporation for an amount equal to the fair market value of the assets and will recognize gain or loss on the deemed sale. IRC § 336(a). If the liquidating corporation distributes certain types of property to a “related person” within the meaning of IRC § 267, IRC § 336(d)(1)(A) precludes recognition of loss.
 - (i) A “C” corporation pays the tax on the deemed sale at the entity level;
 - (ii) As “S” corporation does not pay tax on the deemed sale at the entity level; the gain passes through to the shareholders.
- b. Shareholders recognize gain or loss equal to the difference between their adjusted basis in their stock and the amount of cash and the fair market value of property distributed to them, reduced by the amount of liabilities assumed or subject to which the shareholder takes the property. IRC § 331(a).
 - (i) If the stock was a capital asset to the shareholder, the gain or loss will be a capital gain or loss to the shareholder and will be long-term if the shareholder held the stock for more than one year. IRC §§ 1221, 1222.

N. *Compensatory Issues*

1. Reasonable Compensation

- a. IRC § 162 allows the deduction of “reasonable compensation” for services rendered.
- b. While each type of entity may have “reasonable compensation” issues, the question has the greatest significance in the context of “C” corporations. The issue generally arises in connection with compensation paid to a shareholder who also performs services to the corporation.

See e.g., Elliotts, Inc. vs. Comm'r, 716 F. 2d 1241 (9th Cir. 1983).

- c. The IRS may determine that compensation paid to a shareholder-employee is unreasonably high and is in fact a disguised dividend. The corporation's deduction for the amount of compensation deemed unreasonable would be disallowed and the amount taxable to the shareholder as a dividend rather than compensation.
- d. Reasonable compensation issues are less significant in the case of partnerships and "S" corporations since income is passed through to the partners or S corporation shareholders regardless of whether it is characterized as compensation or as their share of profits. The issue could arise in the case of compensation paid to a family member of a partner or shareholder that the IRS deems is in fact a gift rather than compensation. IRC § 1366(e) grants the Internal Revenue Service authority to reallocate items passed through to members of a family group where necessary to adequately compensate those shareholders performing services.
- e. The Internal Revenue Service has reallocated dividends paid in lieu of reasonable compensation to officer-shareholders of S corporations as wages subject to employment taxes. *See* Rev. Rul. 74-44, 1974-1 C.B. 287; Rev. Rul. 73-361, 1973-2 C.B. 331; *Spicer Accounting, Inc. vs. U.S.*, 918 F. 2d 90 (9th Cir. 1990).

2. Fringe Benefits

- a. Generally, sole proprietors, partners and, pursuant to IRC § 1372, S corporation shareholders who own more than 2% of the stock are deemed to be "self-employed" and not entitled to many of the fringe benefit tax advantages accorded to employees under the Internal Revenue Code. *See e.g., IRC §§ 79(a), 105(g), 119(a), 125(d)(1)*.
- b. Shareholder-employees qualify for many benefits accorded to employees with respect to fringe benefits since they are "employees" for federal income tax purposes. However, non-discrimination rules apply in many cases to prevent corporations from providing tax-advantaged benefits to the shareholder-employees but withholding the same benefits from the rank and file employees. *See, e.g., IRC § 79(d)(1), 125(b)*.

3. Retirement Plans

In the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), H.R. 4961, § 237-238, the most significant differences between corporate and non-corporate retirement plans were eliminated. Self-employed plans (i.e., those maintained by partnerships) are still subject to more onerous restrictions than those applicable to corporate employees.

4. Estate Planning

The opportunities for estate planning for each type of entity should be evaluated, particularly for closely-held entities. Considerations include, but are not limited to, the potential valuation of equity interest that may be obtained through use of a particular form of entity, ability to transfer ownership interests to family members without adverse tax consequences, ability to maintain control of the business, ability to plan for succession, availability of special provisions such as IRC § 303.

O. *Multiple Entities*

1. Controlled groups of corporations as defined in IRC § 1563 are treated as one corporation for the purpose of determining the taxable income bracket of the group, the \$250,000 allowance for computing the accumulated earnings tax credit, the \$40,000 exemption for alternative minimum tax purposes, and the \$2 million exemption for computing the superfund tax. IRC § 1561(a).
2. Affiliated groups of corporations as defined in IRC § 1504 may elect to file a consolidated return rather than separate corporate tax returns. Consolidation permits the group to offset the operating losses of one member against the taxable income of other members, make tax-free intercorporate tax distributions, and engage in intercompany transactions without incurring taxable gain or loss. IRC § 1502.
3. “S” corporations can own subsidiaries that are C corporations. The C corporation subsidiaries can elect to file a consolidated return even though the S corporate parent is excluded. IRC § 1504(b)(8). An S corporation cannot be owned by either a C corporation, a partnership or an LLC. IRC § 1361.
4. “S” corporations can also own “qualified Subchapter S Subsidiaries” (“QSSS”), which are domestic corporations not otherwise ineligible for S status that is 100% owned by the S corporation and which the S corporation elects to treat as a QSSS.

For tax purposes, the QSSS is not treated as a separate entity and its assets, liabilities, income, expenses and other tax items are treated as those of the parent S corporation. IRC § 1361(b)(3).

5. Partnerships can be partners in other partnerships. Special rules apply to tiered partnership arrangements, including special rules regarding the inclusion of liabilities of a lower-tier partnership into account for determining the basis in upper-tier partnership interests (Treas. Reg. § 1.752-4), rules to preclude deferral by use of different fiscal years for tiered partnerships (IRC § 706(d)(3), and rules regarding termination of a lower-tier partnership upon the transfer of interests in the upper-tier partnership (Treas. Reg. § 1.708-1(b)(1)(ii)). Tiered partnerships significantly increase the complexity of drafting partnership and operating agreements and allocated income and losses.

VI. CORPORATE LAW AND STATE TAX ISSUES

A number of state corporate and tax issues must be taken into account in selecting the type of entity to form for conduct of a trade or business and the laws of the state of formation and the states in which the entity will conduct business should be reviewed thoroughly.

A. State Tax Issues

1. Since a sole proprietorship is taxed at the individual owner level, income and expenses will be taxed at the individual state income tax rate applicable to the individual owner.
2. Many states impose an annual fee on entities such as corporations, limited partnerships, and limited liability companies. California imposes an \$800 minimum tax on corporations, limited partnerships and limited liability companies. This minimum tax is not imposed on general partnerships or sole proprietorships. California Revenue & Taxation Code §§ 17935, 17941, 23151.1 and 23800.5(b)(1)(B).
3. Some states imposed a reduced tax on the taxable income of “S” corporations. California imposes an entity level tax at the rate of 1.5% of the taxable income of an “S” corporation formed in California or doing business in California. California Revenue & Taxation Code § 23802(b).
4. Most states do not impose an entity level tax on limited liability companies. California is an exception. It imposes a tax on the gross receipts of a limited liability company either formed in California or doing business in California. The gross receipts tax

currently ranges from \$ 900 on gross receipts between \$250,000 and \$500,000 and \$ 11,790 on gross receipts in excess of \$5 million. California Revenue & Taxation Code § 17942. Some limited liability companies have converted to limited partnerships to avoid the gross receipts tax.

B. Federal and State Corporate and Securities Law Issues

1. Each state has laws that govern the formation and operation of the different forms of entities used to conduct business. Some provisions can be overridden by the written agreement of the shareholders, partners or members. Others cannot. The corporate laws of the state selected as the state of formation and the corporate laws in which the business will be conducted should be reviewed to insure that the owners will be able to achieve their business objectives in terms of management, continuity, future mergers and consolidations, and overall operation of the business.
2. An important provision in the California laws that apply to corporations formed or doing business in California is Section 500 of the California Corporations Code. To protect creditors from shareholders draining corporations from all of its profits, Section 500 prohibits distribution of profits to corporate shareholders unless the corporation has a specified amount of assets.
3. The issuance of stock, limited partnership interest and, in some cases, membership interests in LLCs are generally subject to state securities laws and their issuance must either fall within an exemption from registration or they must be registered with the appropriate state agency. A commonly used exemption in California for closely held entities is Section 25102(f) of the California Corporations Code.
4. The issuance of securities must also come within an exemption from registration under the Federal securities laws or be registered with the SEC before they are issued.

VII. EXIT STRATEGY CONSIDERATIONS

A. *Factors*

1. Taxable versus Tax-Free Transactions
2. Character of Gain or Loss
3. Potential for Double Taxation

4. Tax Basis of Equity Interests
5. Tax Basis of Assets
6. Tax Rates
7. Purchaser's Tax Position

B. *Sales To Third Parties*

1. Taxable Sale of Stock

- a. If stock is sold in a taxable transaction for cash, a note, or other property, the seller will recognize gain or loss equal to the difference between the amount realized on the sale and the seller's adjusted tax basis in the stock sold. IRC §1001. Such gain or loss will generally be long-term capital gain or loss or short-term capital gain or loss depending on the seller's holding period in the stock. IRC §§1221, 1222.
- b. The seller will be subject to a single level of tax, but the corporation's "inside basis" in its assets will not change.
- c. The seller may be prohibited from claiming a loss on the stock sale if the stock is sold to a related party. IRC §§267, 707.
- d. If stock is sold in exchange for a note or under an installment payment arrangement, installment sale treatment is available unless the stock is publicly traded or the seller is a dealer in such property. IRC §453.
 - (i) IRC §453A may impose an interest charge on installment obligations outstanding as of the end of the year if the total face amount of such obligations that arose during the year and remain outstanding as of the close of the year exceeds \$5M.
 - (ii) If the installment obligation is pledged for a loan, the proceeds of the loan will be treated as a payment on the installment obligation (i.e., trigger gain recognition). IRC 453A(d)(1).
- e. Under certain circumstances, the transaction may be eligible for and the parties may want to make an election under IRC §338(h)(10) election.

(i) Eligibility

- (a) Election can only be made in the context of a “qualified stock purchase.” Treas. Reg. IRC §1.338(h)(10)-1(c). A “qualified stock purchase” requires that the buyer purchase at least 80% (by vote and value) of the corporation’s stock within a 12-month period. IRC §338(d)(3). The buyer and the corporation acquired cannot be related parties. IRC §338(h)(3).
- (b) Stock acquired must be in a corporation that is a member of an affiliated or consolidated group, or that is an S corporation (but not the parent corporation). Treas. Reg. IRC §1.338(h)(10)-1(c).
- (c) Only corporate acquirers are eligible to make a 338(h)(10) election. Treas. Reg. §1.338-3(b).

(ii) When does it make sense?

- (a) Gain on the sale of stock would exceed the gain from a deemed asset sale.
- (b) The marginal cost of the election to Seller (that is, the difference between the asset sale gain and the stock sale gain) is less than the present value of the benefits derived by buyers from the deemed asset sale.
- (c) Where the loss disallowance rules would apply to the stock sale.
- (d) Where seller has a CFC and converting passive stock gain into "general limitation" income increases the seller’s ability to use foreign tax credits.

f. Seller may be entitled to certain special tax incentives if the stock sold is “qualified small business stock.”

- (i) IRC §1045 allows for the “rollover” (i.e., tax deferral) of gain realized on the sale of stock in a corporation that is a “qualified small business corporation” into stock of another corporation that

is a “qualified small business corporation.” Applies to C corporations only.

- (ii) IRC §1202 provides for the exclusion of 50% of the gain recognized on the sale of stock in a corporation that is a “qualified small business corporation.” Applies to C corporations only.
- (iii) IRC §1244 provides for ordinary loss treatment on the sale of stock in a corporation that is a “small business corporation.” Applies to C corporations and S corporations.
- (iv) There is a difference in the tests to determine whether a corporation is a “qualified small business corporation” (for purposes of IRC §§1045 and 1202) and a “small business corporation” (for purposes of IRC §1244).
 - (a) Qualified small business corporation—Corporation had no more than \$50,000,000 in gross assets up through the time it issued the stock and had no more than \$50,000,000 in gross assets immediately after the issuance.
 - (b) Small business corporation—Aggregate amount of money and other property received by the corporation for its stock through the date of issuance (as a contribution to capital, and as paid-in surplus) did not exceed \$1,000,000.

2. Tax-Free Stock Reorganizations

a. Consequences

- (i) Seller does not recognize gain on the transaction except upon and to the extent of the receipt of “boot.” IRC §§354, 356.
 - (a) Non-qualified preferred stock constitutes “boot” for purposes of the reorganization provisions. IRC §356(e).
- (ii) The basis of the stock and securities (other than “non-qualified preferred stock”) received by seller is the basis of the stock or securities relinquished,

decreased by the amount of cash and the fair market value of any other property received by seller and the amount of any loss recognized by seller, and increased by the amount of gain recognized by seller on the exchange and any amounts treated as a dividend. IRC §358.

- (iii) Buyer takes a carryover basis in the stock acquired, increased by the amount of gain recognized to the transferor on such transfer. IRC §362.

b. Types

- (i) “B” Reorganization—Sale of stock solely in exchange for all or a part of the voting stock of the acquiring corporation (or all or a part of the voting stock of a corporation which is in control of the acquiring corporation), if, immediately after the acquisition, the acquiring corporation has “control” of the acquired corporation. IRC §368(a)(1)(B).
- (ii) Reverse Triangular Merger—
 - (a) 80% controlled subsidiary merges into the “acquired corporation”;
 - (b) Selling shareholders receive voting stock of the merged corporation’s parent in exchange for at least 80% of the “acquired corporation’s” stock;
 - (c) The “acquired corporation” must hold “substantially all” of the properties of the merged corporations. IRC §368(a)(2)(E).

3. Sale of Membership or Partnership Interests

- a. The seller will generally recognize gain or loss on a sale of membership interests or partnership interests. IRC §1001.
- b. Although the gain or loss will generally be treated as long-term or short-term capital gain or loss based on the seller’s holding period (IRC §§741, 1222), IRC §751 may cause a portion of any such gain or loss being treated as ordinary.
- c. The seller may be prohibited from claiming a loss on the sale of the membership interest or partnership interest if the sale is to a related party. IRC §§267, 707.

- d. If the sale results in a member or partner owning 100% of the interests in the LLC or partnership, the entity converts to a “disregarded entity.” The seller’s treatment on such transaction is as described above. However, for purposes of determining the buyer’s basis in the assets, the LLC or partnership is deemed to have made a liquidating distribution of all of its assets to the members or partners, and following this deemed distribution, the buyer is treated as having acquired the assets deemed to have been distributed to the seller. Rev. Rul. 99-6.
- e. If the sale results in a “termination” of the LLC or partnership under IRC §708(b)(1)(B) (which occurs when there have been sales or exchanges of interests representing 50% or more of the total interest in partnership capital and profits within a 12-month period), there is the potential for adverse tax consequences to the remaining partners, including, among other things, the potential for a “bunching of income or losses” (i.e., more than one year’s worth of the LLC or partnership’s income being reported on a member/partner’s tax return) if the LLC/partnership has a tax year different from the member/partner’s tax year, and a “re-start” of depreciation on the remaining basis in the LLC or partnership’s depreciable assets.
- f. The seller of a membership interest or partnership interest may lose the ability to utilize losses from the LLC or partnership that may have been suspended under certain rules limiting a member’s right to claim such losses in a given tax year. IRC §704(d).
- g. The tax-free reorganization provisions are not available to sellers of LLCs and partnerships, but a seller may be entitled to tax-free treatment (or partial tax-free treatment) under IRC §351 (if the seller receives stock in a corporate acquirer) or IRC §721 (if the seller receives membership interests or partnership interests in another LLC or partnership).

4. Taxable Sale of Assets by a Corporation

- a. Generally, the corporation will recognize gain or loss on the sale of the assets, IRC §1001, and the shareholders of the corporation will also recognize income when the corporation makes distributions to the shareholders, on liquidation or otherwise (i.e., there is double taxation on the corporation’s earnings), IRC §301.

- b. The character of any gain or loss recognized on a sale of assets generally will depend on whether the assets sold are capital assets under IRC §1221 (or are treated as capital assets under IRC §1231) or ordinary income assets. However, under certain “recapture” rules, all or a portion of the gain recognized on the sale of a capital asset may be treated as ordinary income. IRC §§1245, 1250.
 - c. The selling corporation may be prohibited from claiming losses on the sale if the sale is to a related party. IRC §§267, 707.
 - d. Subject to certain exceptions, if the assets are sold in exchange for a note or under an installment payment arrangement, installment sale treatment may be available. IRC §453.
5. Tax-Free Asset Reorganizations
- a. Consequences
 - (i) The selling corporation does not recognize gain, even on “boot,” so long as such boot is distributed to shareholders or creditors pursuant to the plan of reorganization. IRC §361(b).
 - (ii) To the extent that it may be relevant, the selling corporation’s basis in the acquiring corporation’s stock or securities will be the selling corporation’s basis in the assets transferred, less the money and the fair market value of other property received and the amount of the selling corporation’s liabilities assumed by the acquiring corporation, plus the amount of any gain recognized by the selling corporation on the exchange. The selling corporation’s basis in other property received will be the fair market value of such property. IRC §358.
 - (iii) The selling corporation recognizes gain (but not loss) on the distribution to its shareholders of property other than “qualified property” (generally, stock or securities in the selling corporation or acquiring corporation. However, the selling corporation’s basis in such property will generally equal the fair market value of the property. IRC §361(c).

- (iv) The selling corporation's shareholders will not recognize gain on the receipt of the acquiring corporation's stock (other than "non-qualified preferred stock") in exchange for stock or securities, and will not recognize gain on the receipt of the acquiring corporation's securities in exchange for securities to the extent that the principal amount of the acquiring corporation's securities do not exceed the principal amount of the securities surrendered. IRC §354.
- (v) The selling corporation's shareholders will recognize gain to the extent of boot received, IRC §356, including:
 - (a) Excess principal amount of the acquiring corporation's securities over principal amount of securities surrendered. IRC §356(d).
 - (b) Non-qualified preferred stock. IRC 356(e).
- (vi) Gain recognized by selling corporation's shareholders will be treated as a dividend if the selling corporation shareholder's receipt of boot "has the effect of the distribution of a dividend." Otherwise, the gain will be treated as capital gain. IRC §356(a)(2).
- (vii) Each selling corporation shareholder's basis in stock or securities received tax-free will be the basis of the property exchanged by such shareholder, decreased by the amount of cash and fair market value of any other property received by the taxpayer, and the amount of loss recognized by such shareholder on the exchange, and increased by the amount of gain recognized by seller on the exchange and any amounts treated as a dividend. The basis of any other property received will equal such property's fair market value. IRC §358.

b. Types

- (i) "A" Reorganization—Statutory merger or consolidation of domestic corporations using enough stock to meet continuity of interest test. IRC §368(a)(1)(A).

- (ii) Forward Subsidiary Merger—An 80% controlled subsidiary acquires “substantially all of the assets” of the acquired corporation in exchange for its parent’s (voting or nonvoting) stock, and the merger would have qualified as an “A” reorganization had the acquired corporation been merged into the parent instead of the subsidiary. IRC §368(a)(2)(D).
- (iii) “C” Reorganization—An acquisition of “substantially all” of the assets of a corporation another corporation in exchange “solely” for all or a part of the acquiring corporation’s voting stock or the voting stock of a corporation that controls the acquiring corporation. The corporation whose assets are acquired must distribute all of the stock, securities or other properties it receives, as well as its other properties, in pursuance of the plan of reorganization. IRC §368(a)(1)(C).
- (iv) “D” Reorganization—A transfer by a corporation of all or a part of its assets to another corporation where, immediately after the transfer, the transferor corporation or one or more of its shareholders (or a combination thereof) is in control of the corporation to which the assets are transferred. Stock or securities of the controlled corporation must be distributed pursuant to the reorganization in a transaction qualifying under IRC §§354, 355, or 356. IRC §368(a)(1)(D).

6. Sale of Assets by an LLC or Partnership

- a. Generally, the selling entity will recognize gain or loss that will flow through to the members/partners. IRC §1001, 701. The character of such gain will be determined at the partnership level. IRC §702.
- b. The selling entity may be prohibited from claiming losses on the sale if the sale is to a related party. IRC §§267, 707.
- c. The tax-free reorganization provisions are not available to LLCs and partnerships, but the LLC or partnership may be entitled to tax-free treatment (or partial tax-free treatment) under IRC §351 (if it receives stock in a corporate acquirer) or IRC §721 (if it receives membership interests or partnership interests in another LLC or partnership).

C. *Redemptions*

1. Stock Redemptions—see Section V.L. above
 - a. Subject to exception for a corporate shareholder owning 80% or more of a corporation's stock, a shareholder will recognize gain or loss on the receipt of cash or other property in exchange for the shareholder's stock, and such gain will generally be treated as capital gain. However, certain tests will be applied to determine whether the cash or other property received should be treated as a dividend, and dividend treatment is possible even in the case where a shareholder does not retain any stock. IRC §302.
 - (i) Certain family and entity attribution rules will apply in determining whether dividend treatment should apply. IRC §§302(c)(1), 318.
 - (ii) Shareholders should be aware that they may be able to waive certain of these attribution rules in order to avoid dividend treatment. IRC §302(c)(2).
2. Redemption of Membership/Partnership Interests—See Section V.L. above.
3. Complete Liquidations—see Section V.M. above.

D. *Public Offerings*

1. Corporations
 - a. If the business has been formed as a corporation, no restructuring of assets is necessary to undertake a public offering.
 - b. The issuance of shares by the corporation is tax-free to the corporation. IRC §1032.
2. LLCs/Partnerships
 - a. There are three methods by which an LLC or partnership can be incorporated, and in each case the incorporation may be accomplished on a tax-free basis depending on basis and liability issues. See IRC §§351, 357(c).
 - (i) Members/partners transfer their interests in the LLC/partnership to a new corporation in exchange for stock;

- (ii) LLC/partnership transfers its assets and liabilities to a new corporation in exchange for stock, which stock is distributed to the members/partners in liquidation;
 - (iii) LLC/partnership distributes its assets to its members/partners, who then contribute these assets to a new corporation in exchange for stock.
 - b. If the public offering takes place at the same time as the incorporation transaction, the new investors would be included in the “transferor” group for purposes of IRC §351.
 - c. If there is a secondary offering that takes place as part of the incorporation and primary offering, and more than 20% of the corporation’s stock is sold in the secondary offering, it would take the incorporation transaction and the primary offering outside the scope of IRC §351.
- 3. UPREIT, or barnesandnoble.com, Structures
 - a. Involves the use of a corporation and an LLC to realize the benefits of flow-through tax treatment while having a structure in place through which the business can be taken public.
 - b. The disadvantage of these structures is that they are more complex than a straight corporate structure and thus investors may be less receptive.

E. *Tax-Free Spin-Offs*

- 1. Types
 - a. Spin-Off—A parent corporation distributes stock of a controlled corporation to the shareholders of the parent corporation on a pro rata basis without any surrender of stock by them.
 - b. Split-Off—A parent corporation distributes stock of a controlled corporation to some or all of the parent corporation shareholders in exchange for all or a part of their stock in the parent corporation. This is the method often used to split up a business in the context of shareholder conflicts.

- c. Split-Up—A parent corporation distributes stock of two or more controlled corporations to the parent corporation shareholders in liquidation. It may or may not be on a pro rata basis with respect to each controlled corporation.
2. Requirements for tax-free treatment
- a. Immediately after the distribution, the parent corporation and the distributed corporation(s) must be engaged in the “active conduct” of a “trade or business” that was in existence for the five-year period preceding the distribution. IRC §§355(a)(1)(C), 355(b).
 - b. There must be a corporate business purpose for doing the spin-off. Treas. Reg. §1.355-2(b).
 - c. The parent corporation must control (by 80% of vote and value) the controlled corporation(s) immediately before the distribution. IRC §355(a)(1)(A).
 - d. The parent corporation must distribute all of the controlled corporation stock to the parent corporation’s shareholders (or an amount of stock representing control, where the retention of any stock is not for the purpose of avoiding federal income tax and is consistent with the business purpose). IRC §355(a)(1)(D).
 - e. The distribution must not be used as a device for the distribution of the earnings of the parent corporation or the controlled corporation(s). IRC §355(a)(1)(B).
 - f. As a group, the shareholders of the parent corporation must have a continuing interest in the parent corporation and controlled corporation(s). IRC §355(e).
 - g. There must be a continuation of the operations of the business or businesses of the parent corporation and controlled corporation(s). See Treas. Reg. 1.355-1(b).

F. *Transfers to ESOPs*

- 1. IRC §1042 provides for a deferral of any long-term capital gain recognized on the sale of securities to an ESOP if:
 - a. The security sold is a security issued by a domestic C corporation that has no class of publicly-traded stock, and the seller’s holding period in the stock is 3 years or more;

- b. Immediately after the sale, the ESOP owns at least 30% of each class of stock of the corporation or at least 30% of the total value of all outstanding stock of the corporation; and
- c. The proceeds from the sale are reinvested in “qualified replacement property” within the period beginning 3 months before the sale and ending 12 months after the sale.
 - (i) “Qualified replacement property” is any security issued by a domestic “operating corporation” which:
 - (a) did not, for the taxable year preceding the year of purchase, have passive income in excess of 25% of its gross receipts; and
 - (b) is not the same corporation that issued the security being replaced or a member of the same controlled group.
 - (ii) An “operating corporation” is a corporation more than 50% of the assets of which are used in the active conduct of a trade or business at the time of purchase or before the end of the replacement period.