BUSINESS ENTITIES

12

Learning Objectives

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Advise clients on selection of a business entity
- ✔ Consider the effect of entity selection on taxability of cancellation of debt income
- ✔ Apply current and proposed rules regarding allocation of entity liabilities among partners or LLC members
- ✔ Consider series limited liability companies as a business form
- ✔ Gain some insight on various LLC issues
- ✔ Be alert for problems of accidental partnerships
- ✔ Be aware of important issues regarding the compensation of business owners

Introduction

Business owners can choose the tax classification of their business entities. Each classification has its pros and cons, so it's important to understand how issues such as forgiveness of debt, protection from liabilities, and compensation of owners play out in each type of entity. This chapter discusses those issues.

Recent editions of the *National Income Tax Workbook* have included detailed discussions of entity selections and have compared disregarded entities, partnerships, S corporations, and C corporations for a variety of tax issues.

In 2014 Chapter 8 dealt with a comparison of a single-owner entity as a disregarded entity or an S corporation. It analyzed the issues such as election formalities, contributions of property to the entity, compensation, income losses, and transfers to other family members.

In 2013 Chapter 11 contained a detailed discussion of the purchase and sale of a business entity, comparing the rules for C corporations, S corporations, and partnerships. It covered sales of assets, sales of stock or partnership interests, and some special elections that could cause a stock sale to be treated as an asset sale for income tax purposes.

In 2012 Chapter 13 discussed S corporation shareholder basis, I.R.C. § 1244 losses on small business corporation stock, abandonment of property, personal service corporations, businesses under common control (updated and included in this chapter for 2015), and distributions from businesses.

In 2011 Chapter 13 covered reasonable compensation issues, S corporation shareholder basis, and some financial distress issues.

ISSUE 1: CANCELLATION OF DEBT INCOME

Cancellation of debt income may be taxable or tax-free to entity owners, depending on the tax classification of the entity.

In general, the economic benefit from eliminating or reducing debt must be taken into account for tax purposes. The tax consequences depend in part on the context of the reduction. For example, debt reduction may take the form of a gift, a sale of property with debt assumed, compensation, or some other deal between the debtor and the creditor. When it does not clearly fit into any other context, the debtor must treat the cancellation of debt (COD) as income [I.R.C. § 61(a)(12)]. Thus, the reduction of the debt is part of the debtor's gross income under general income tax rules. However, there are some specific exceptions that allow the debtor to exclude this income. I.R.C. § 108 lists these situations and describes the conditions and correlative items for each.

- Discharge of debt in a federal or state bankruptcy proceeding [I.R.C. § 108(a)(1)(A)]
- Discharge of debt when the taxpayer is insolvent [I.R.C. § 108(a)(1)(B)]
- A reduction of qualified farm indebtedness [I.R.C. § 108(a)(1)(C)]
- An election to exclude qualified real property business indebtedness if the debtor is not a C corporation [I.R.C. § 108(a)(1)(D)]
- Qualified principal residence indebtedness, subject to renewal by Congress after 2014 [I.R.C. § 108(a)(1)(E)]
- Reduction of purchase money debt held by the seller [I.R.C. § 108(e)(5)]
- Limited reductions of student loans where the former student works in certain designated occupations [I.R.C. § 108(f)]

Observation Discussion Limited to Business Debts

This discussion is limited to situations where the type of taxable entity might affect the treatment of COD income; thus, residence debt and student loan debt are not part of this material.

Exclusion Rules

I.R.C. § 108 is the sole provision of the Internal Revenue Code that provides for exclusion of COD income. The Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, inserted most of the current language into I.R.C. § 108, although it has been amended several times since then. I.R.C. § 108 also provides some trade-offs for excluding COD income, in the form of various tax attribute reductions.

Practitioner Note Effect of Entity Selection

When the debtor is an unincorporated entity, the classification of the entity for tax purposes may have a profound effect on the taxation of the owner or owners. A disregarded entity or partnership has a combination of owner and entity tax attributes. In contrast, an S corporation separates most of the attributes from its shareholders and is subject to entity-level exclusion tests. A C corporation provides few, if any, advantages over the S corporation in the context of COD income and is unable to use the qualified business real property indebtedness exclusion.

Bankruptcy

To qualify for the bankruptcy exclusion, the debt must be discharged or reduced by a court in a bankruptcy proceeding. In addition, the taxpayer must be a party to the proceeding [I.R.C. § 108(d)(2)].

Insolvency

The main difference between bankruptcy and insolvency is that bankruptcy is a legal status. In contrast, insolvency occurs when the aggregate fair market value (FMV) of a taxpayer's property is less than the aggregate amount of the taxpayer's debts [I.R.C. § 108(d)(3)]. Even though certain assets might be subject to the federal exemption provided by the Bankruptcy Code or might be subject to a state exemption, a taxpayer cannot exclude them from the asset base when attempting to claim the insolvency exclusion of I.R.C. § 108(a)(1)(B) [*Johns v. Commissioner*, T.C. Summary Opinion 2001-67; *Carlson v. Commissioner*, 116 T.C. 87 (2012); T.A.M. 1999-35-002 (May 3, 1999)]. For example, in many states an individual's retirement accounts may be beyond the reach of creditors. However, the value of these assets must be considered in the determination of solvency or insolvency.

Qualified Farm Indebtedness

For a taxpayer who is not bankrupt or insolvent, the Internal Revenue Code provides special treatment for the cancellation of qualified farm indebtedness. To qualify for this treatment, 50% or more of the debtor's aggregate gross receipts in the 3 taxable years preceding the year of discharge must have come from an active farming trade or business [I.R.C. § 108(g)(2)(B)].

The debt reduced under the qualified farm indebtedness rules must have been incurred in the farming business [I.R.C. § 108(g)(2)(A)]. The amount of debt reduction excluded under these provisions may not exceed the "adjusted tax attributes of the debtor" [I.R.C. § 108(g)(3)(B)], plus the adjusted basis of "qualified property." The attributes are those listed later, which a bankrupt or insolvent taxpayer must reduce (after reduction for any prior insolvency or bankruptcy of the same taxpayer).

The qualified property is any property used in any trade or business (not just in the farming business) or for the production of income [I.R.C. § 108(g)(3)(C)]. Any amount of debt reduction in excess of the attributes, including basis of qualified property, is included in the debtor's gross income.

Practitioner Note Personal Use Property

The basis of property the taxpayer uses for personal rather than business purposes is not a tax attribute for qualified farm indebtedness as it is for debt discharged in bankruptcy or when the taxpayer is insolvent.

Qualified Real Property Business Indebtedness

The reduction of qualified real property business indebtedness is another possible exclusion [I.R.C. § 108(c)]. In general, this rule allows a solvent debtor to exclude reduction of debt from gross income. Any taxpayer other than a C corporation may qualify for this exclusion [I.R.C. § 108(a)(1)(D)]. This exclusion applies to discharges of debt that occur after December 31, 1992.

The debt must have been incurred or assumed in connection with real property used in an active trade or business and must be secured by that real property [I.R.C. § 108(c)(3)(A)]. If the debt was originally incurred after December 31, 1992, it must have been incurred in order to acquire, improve, or rehabilitate real property used in the taxpayer's business [I.R.C. § 108(c)(3)(B)].

I.R.C. § 108(c)(2) limits this exclusion to the lesser of

1. the excess of the debt secured by the qualified real property over the property's FMV, or
2. the aggregate of the adjusted bases of the taxpayer's depreciable real property.

Purchase Money Debt Reduction

When the seller of property subsequently agrees to a reduction of a purchase money debt, there is no gross income to the debtor. The debtor must not be insolvent, and the debt must not be discharged in bankruptcy [I.R.C. § 108(e)(5)(B)]. In exchange for the exclusion, the debtor must reduce the basis of the property secured by the debt [I.R.C. § 108(e)(5), flush language]. The taxpayer does not make an election and cannot claim any other tax treatment.

Attribute Reduction

In most cases the exclusions provided by I.R.C. § 108 are not "free," as is the case with much state and local bond interest, items received as gifts or by inheritance, and the like. In exchange for the bankruptcy and insolvency exclusions, the taxpayer must reduce or eliminate certain favorable tax attributes, in the following order [I.R.C. § 108(b)(2)]:

1. Net operating loss of the year of discharge
2. Net operating loss carryover to that year
3. General business credit carryforward
4. Alternative minimum tax credit for the year of the discharge and the carryforward from years prior to discharge
5. Capital loss of the year of discharge
6. Capital loss carryover to the year of discharge
7. Reduction of basis of all property held by the taxpayer
8. Passive activity loss and credit carryforwards from the year of the discharge
9. Foreign tax credit carryover

A taxpayer may elect to reduce basis of depreciable property and certain other assets before the previously listed attributes [I.R.C. § 108(b)(5)]. Most of these attributes remain intact for the year of the debt discharge and are reduced or eliminated on the first day of the following year.

When a taxpayer claims the qualified farm indebtedness, qualified real property business indebtedness, or purchase money debt exclusion, the target attribute is the basis of the property to which the debt relates.

Observation Attribute Reductions Are Complicated

This material provides only a brief overview of COD income exclusion and attribute reduction rules. The rules become even more complicated when there are disregarded entities, partnerships, and S corporations involved.

Effect of Entity Classification on Debt Discharge

Taxable income of an individual, a C corporation, or an estate or trust (except for trusts that make certain distributions) has no effect on the tax liability of any other taxpayer. The rules regarding debt discharge for these taxpayers are reflective of their self-contained status. Accordingly, each of the tests for bankruptcy exclusion is applied at the individual or C corporation level.

However, when the debtor is a disregarded entity or a pass-through entity, the income of that entity may affect the income of the owners. Thus, the tax professional must ascertain the relationship between the entity, its owner or owners, and the particular exclusionary rules of I.R.C. § 108.

Disregarded Entity

For nontax purposes a single-member limited liability company (SMLLC) may be treated as an entity apart from its owner. However, a domestic SMLLC is disregarded for income tax purposes, unless its owner elects to have it taxed as a corporation [Treas. Reg. § 301.7701-3(b)(1)(ii)]. Certain subsidiary corporations owned by S corporations and real estate investment trusts (REITs) are also disregarded entities for federal income tax purposes [I.R.C. §§ 1361(b)(3) and 856(i)(2)]. A third disregarded entity is a grantor trust, which exists when a person retains certain powers after transferring property to a trust [I.R.C. §§ 671 through 678].

When any of these disregarded entities has a discharge of debt and the owner of the entity is not personally liable, there may be some interpretive problems. The IRS has addressed this situation in a proposed regulation, which combines the entity with its owner for purposes of the bankruptcy and insolvency exclusions [Prop. Treas. Reg. § 1.108-9]. According to this position, a discharge of a disregarded entity's debt in bankruptcy requires that the owner as well as the entity be parties to the bankruptcy proceedings.

Example 12.1 Bankruptcy of SMLLC/ Disregarded Entity

Deb Torr owns all of DT, LLC, which is an SMLLC. DT, LLC was in serious financial difficulty and filed for bankruptcy protection. The bankruptcy court discharged $100,000 of DT, LLC's liabilities. If Deb was not a direct party to the bankruptcy, Prop. Treas. Reg. § 1.108-9 denies Deb the exclusion for COD because she was not under the jurisdiction of the court. However, it is likely that she was a direct party because she had to file for bankruptcy protection to have DT's debt discharged.

Practitioner Note Extent of Bankruptcy Exclusion Unclear

If indebtedness of a disregarded entity or grantor trust is discharged in bankruptcy, Prop. Treas. Reg. § 1.108-9 applies I.R.C. § 108(a)(1)(A) to an owner of the grantor trust or disregarded entity only if the owner is under the jurisdiction of the bankruptcy court. If the owner of the disregarded entity (or grantor of the trust) has guaranteed the debt, and the bankruptcy proceeding involves the owner of the disregarded entity, it appears that the bankruptcy exclusion applies, because the owner is under the supervision of the court.

The same proposed regulation limits the insolvency rule to situations in which the owner of the disregarded entity is insolvent. The owner must compare the FMV of all assets owned, including those owned by the disregarded entity, with all of the owner's liabilities, including those incurred by the disregarded entity.

Partnerships

Consistent with the aggregate theory that treats partnerships and partners as comingled, the I.R.C. § 108 exclusion rules look to the partner, rather than the partnership, to determine the taxable effects of COD income [I.R.C. § 108(d)(6)]. Accordingly, the discharge of partnership debt may be taxable to some partners and excludable for others. Moreover, the partners might qualify for different exclusion provisions.

Example 12.2 Partnership Debt Discharge

The Hopper family owns Hopalong, LLC, which owns and operates a large cattle ranch in Rhode Island. Claude is the active manager of the ranch. His sister Belle manages a posh resort and hotel complex in North Dakota. Their sister Bunny is an aspiring dancer in an off-Broadway theater troupe in Utah. Claude, Belle, and Bunny each own one-third of the interests in Hopalong.

Due to drought conditions in New England, Hopalong faced severe financial difficulties in 2015. Claude arranged a restructuring of loans, which resulted in a $300,000 reduction in the net present value of the future payments. All of the loans were connected with Hopalong's ranching business. There was no bankruptcy proceeding in connection with the debt reduction. The lender sent Hopalong a Form 1099-C, Cancellation of Debt, reporting the $300,000 debt reduction.

Hopalong must show each member's share of the COD income on his or her Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc. Hopalong should clearly indicate that the cancellation was in connection with farm indebtedness, so that any of the members who are active farmers might qualify for the exclusion.

Assume that Claude is solvent and meets the test for the qualified farm indebtedness exclusion. The vast majority of his gross income for the last 3 years is attributable to his share of Hopalong. He excludes his $100,000 portion of Hopalong's COD income.

Belle does not meet the test for the qualified farm indebtedness exclusion. The majority of her gross income for the past 3 years was from her hotel management salary. She has assets whose FMV exceeds the sum of her liabilities, so she is solvent. Therefore, she must include her $100,000 of Hopalong's COD income in her gross income.

Bunny does not meet the test for the qualified farm indebtedness exclusion. Like many aspiring dancers, the majority of her gross income was earned as a waitress in Salt Lake City's theater district. She has student loans and other debts that exceed the FMV of all of her assets. Because she is insolvent, she excludes her $100,000 of Hopalong's COD income.

Practitioner Note No Duplication of Income

I.R.C. § 752 treats all the various partners as sharing in debts of the partnership (see Issue 2 in this chapter). According to these rules an increase in partnership debt is treated as a cash contribution by the partners in proportion to their shares of the increase. A decrease is treated as a cash distribution by the partnership to the partners, in proportion to their shares of the debt reduction. If the distribution exceeds the partner's predistribution basis, the partner may recognize taxable gain on the distribution. Thus, it appears that the distribution rules might circumvent the COD income exclusion rules.

Fortunately, the IRS has ruled that there is no duplication of income in this situation. Each partner who is allocated a portion of the COD income of the partnership increases his or her partnership basis immediately before the distribution [Rev. Rul. 92-97, 1992- 2 C.B. 124; T.A.M. 97-39-002 (May 19, 1997)]. Thus, in Example 12.2 each of the three Hoppers would receive a momentary increase of $100,000 to reflect the COD income and would then erase the basis increase due to the deemed distribution of cash. Even if any of the members had zero basis before the discharge, there would be a sufficient basis increase to absorb the deemed distribution.

Example 12.3 COD Income and Basis Reduction

In Example 12.2 the reduction of Hopalong's debt is treated as a $100,000 distribution to each member [I.R.C. § 752(b)]. If any member has less than $100,000 basis in his or her interest in Hopalong, the excess of the distribution over basis creates recognized gain. However, this is a very unlikely, if not impossible, situation. Each member's share of the COD income increases basis immediately before the distribution, so each of the siblings would have at least $100,000 of basis before reducing it to reflect the debt reduction.

S Corporation

If the taxpayer is an S corporation, the tests for exclusion are made at the corporate level [I.R.C. § 108(d)(7)]. This is in marked contrast to the partnership rules, where all of the tests are applied to the partners, as discussed above [I.R.C. § 108(d)(6)]. This divergence between the treatment of S corporations and the treatment of partnerships is by Congress's design.

Changing Entity Status in Contemplation of Discharge of Debt

The COD income rules differ with the type of entity whose debt is being canceled or reduced. Thus, some entities may wish to change classification in anticipation of an impending debt reduction. On occasion, this may make sense for a C corporation, which might consider electing S corporation status. It may be an appropriate decision for an unincorporated entity, but it would not be advisable without detailed analysis of the ancillary tax problems that could result from the change.

The ability of an entity to change its status depends in part on its local law status. If it is incorporated, it may not elect to be treated as a partnership or as a disregarded entity. Corporations may elect S corporation status, but they have to meet the qualification requirements and follow the timing rules for filing the election.

Changing Nontax Status

Most states permit a corporation to merge into an LLC or other unincorporated entity. Moreover, many states permit the "formless conversion" between corporations and LLCs. For nontax purposes a formless conversion may be a simple task. However, for federal income tax purposes, it is tantamount to the dissolution of one entity and the formation of another of a different type. Generally, if an unincorporated entity becomes a corporation, the immediate tax consequences are not severe. I.R.C. § 351 permits a tax-free exchange of property for stock when the shareholders who contribute property receive stock and the shareholder or shareholders who contributed property in the same exchange own at least 80% of the stock.

However, incorporation is difficult to undo for tax purposes. The corporation must recognize gain or loss on each asset it distributes [I.R.C. § 336]. It computes this by comparing the FMV of each item of property with that item's adjusted basis at the time of the distribution. The corporation reports the net gain or loss on its tax return for the year that ends with the liquidation. This rule applies to both C and S corporations, although the incidence of income tax differs for these two entities.

Each shareholder must recognize gain or loss on the receipt of property. The gain or loss is the difference between the net FMV of assets less liabilities received, compared to the adjusted basis of the stock immediately before the liquidating distribution [I.R.C. § 331].

Cross-Reference Liquidations and Formless Conversions

- Chapter 13 of the *2011 National Income Tax Workbook* contains discussion and an example of the taxability of a corporate liquidation (see Issue 5).
- Chapter 13 of the *2010 National Income Tax Workbook* contains discussion and an example of the taxability of a formless conversion of a C corporation to an unincorporated entity (see Issue 6).

Changing Tax Status without Changing Nontax Status

A domestic unincorporated entity has a default status for income tax purposes. If the company has multiple owners, it is treated as a partnership. If it has a single owner, it is a disregarded entity [Treas. Reg. § 301.7701-3(b)(1)]. The same regulation, often called the "check the box" regulation, also permits an unincorporated entity to elect to be a corporation. The entity elects to be taxed as a corporation by filing the proper form.

If the entity chooses C corporation status by filing Form 8832, Entity Classification Election, the entity must file this election within 75 days after, or 12 months before, the intended effective date [Treas. Reg. § 301.7701-3(c)(1)(iii)].

If the entity chooses S corporation status as of the first day it is seeking entity classification as a corporation, it files Form 2553, Election by a Small Business Corporation. The entity does not need to file Form 8832 in addition to Form 2553 [Treas. Reg. § 301.7701-3(c)(1)(v)(C)]. (See the section "Filing Form 2553 to Elect S Corporation Status" under Issue 4 later in this chapter for a discussion of filing Form 8832 in connection with an S election for an unincorporated entity.)

The election to be an S or C corporation stays in effect regardless of a change in the identity or number of owners [Treas. Reg. § 301.7701-3(f)(1)]. Once made, an election generally cannot be changed for 60 months. However, a new election may be permitted within 60 months if there has been a change of more than 50% of the ownership interest, and after the change in ownership, the majority is held by persons who were not owners on the date of the earlier election [Treas. Reg. § 301.7701-3(c)(1)(iv)].

Practitioner Note Effect of Entity Election

The election to become a C or S corporation binds the entity to all of the rules applicable to the chosen tax classification. Thus, the entity cannot pick and choose any of the rules that do not fit with its chosen classification. For instance, an unincorporated entity that has an S election in place and then violates one of the S corporation rules, such as the type or number of shareholders or classes of stock, becomes a C corporation. It does not revert to partnership or disregarded entity status unless it is able to revoke the classification election. When it does so, it will be treated as a corporation that completely liquidated.

Example 12.4 Separation from Owner for Bankruptcy Test

Deb from Example 12.1 elected S corporation status for DT, LLC by filing Form 2553 within the proper time frame. The treatment of DT, LLC's COD income is determined only with reference to DT as an entity. Thus, because DT, LLC is in bankruptcy and is the debtor, the COD income is excluded. Deb's financial status is irrelevant. However, Deb does not get a basis increase for the excluded income, although most income items do affect shareholder basis [I.R.C. § 108 (d)(7)(C)].

Example 12.5 Qualified Farm Indebtedness Test for S Corporation

Assume that Hopalong from Example 12.2 elected to become an S corporation. It filed Form 2553 within the appropriate time frame. Substantially all of Hopalong's gross receipts for the past 3 years have been from farming. Hopalong excludes the COD income using the qualified farm indebtedness rule.

Pitfalls Connected with the Corporation Election

As stated in the earlier practitioner note, the corporation election causes the organization to become a corporation for income tax purposes. The conversion from unincorporated to incorporated status requires that the entity and its owner(s) pretend a new corporate body is created, property is transferred to the new entity, and stock is received. Of course, there are no actual transfers of property or changes in the entity for nontax purposes, but the fictional tax transactions must all be taken into account.

One of the problems faced by the proprietor who suddenly becomes a shareholder, or by the partners who are instantly granted shareholder status, is the corporation's assumption of the former owners' share of liabilities. Although liability assumption is generally permitted in a tax-free incorporation [I.R.C. § 357(a)], there are some exceptions. When a troubled entity incorporates, there may be liabilities in excess of the owners' adjusted basis in the property contributed or deemed contributed. In this case the excess of the liabilities over the basis of the property contributed (or deemed contributed in case of a corporation election) is gain the shareholders must recognize [I.R.C. § 357(c)].

Example 12.6 Gain Recognized on Deemed Contribution

Assume that the adjusted basis of Hopalong's assets at the time of the S election in Example 12.5 was $3,000,000. The liabilities, before the agreed reduction of $300,000, were $3,900,000 in the aggregate. Under the tax fictions of I.R.C. §§ 351 and 357, each of the shareholders would be treated as transferring $1,000,000 of assets, subject to $1,300,000 of liabilities. Because each shareholder had transferred liabilities in excess of basis, each would report $300,000 gain on the deemed incorporation. Collectively reporting $900,000 of gain in order to save Belle from reporting $100,000 of taxable COD income is not a sound strategy.

Practitioner Note Shareholder Guarantee

When a shareholder transfers property subject to liabilities in an otherwise tax-free incorporation, the liabilities generally do not cause an issue. However, there are two exceptions.

- If a shareholder transfers any liabilities without a business purpose or with a tax avoidance motive, all of the liabilities taken from that particular shareholder are treated as boot, or cash received by the shareholder in the exchange [I.R.C. § 357(b)].
- If a shareholder transfers liabilities in excess of the aggregate basis in assets transferred by that shareholder, the excess of the liabilities over basis is treated as gain [I.R.C. § 357(c)].

These rules do not require that there be a formal assumption by the corporation. Moreover, a guarantee by one or more shareholders does not affect the treatment of the liabilities for tax purposes. As long as the arrangement anticipates that corporate funds will be used to pay the shareholder's liabilities, the corporation is treated as if it had relieved the shareholder of the debt.

ISSUE 2: ALLOCATION OF PARTNERSHIP LIABILITIES

The Internal Revenue Code treats some or all of the partners as sharing in the debts of the partnership. Depending on the nature of the debt, its association with specific property, and arrangements among the partners, the allocation can become quite complex.

A partnership or limited liability company (LLC) taxed as a partnership is treated as an aggregation of individuals for purposes of the income tax effects of entity liabilities. The tax rules allocate the entity liabilities among the partners and members to determine the income tax effect of the partnership or LLC liabilities on each partner or member.

Practitioner Note Reference to *Partnership* and *Partner*

This issue discusses the income tax rules that apply to partnerships and LLCs taxed as partnerships. For simplicity in referring to both entities, it uses the term *partnership* to mean LLCs under state law that are taxed as partnerships under federal tax law (and state tax law in most cases) as well as partnerships under state law. Similarly, this discussion uses the term *partner* to mean a member of an LLC taxed as a partnership, as well as a partner in a partnership. It refers to LLCs and members of LLCs when the differences under state law between partnerships and LLCs require an explanation.

Effect of Partnership Liabilities on Basis

When a person becomes a partner or acquires an additional interest in a partnership, he or she may get an invisible boost in basis because the increased share of partnership liabilities is treated as an addition to the partner's personal debt, and the proceeds from this debt are deemed contributed to the partnership [I.R.C. § 752(a)].

Thus, altering any partner's interest might cause a reallocation of partnership liabilities among all of the partners.

1. When a partner's share of partnership liabilities increases, the partner is treated as if he or she made a cash contribution in the amount of the increase and adjusts basis in his or her interest upward by the same amount [I.R.C. §§ 752(a) and 721(a)].
2. When a partner's share of partnership liabilities decreases, the partner is treated as if he or she received a cash distribution in the amount of the decrease and adjusts basis in his or her interest downward (not below zero) by the same amount [I.R.C. §§ 752(b) and 733(1)].
3. There can be hypothetical contributions and distributions whenever any event causes the partners' relative shares of partnership liabilities to change.
4. Accordingly, it is extremely important to be able to measure every partner's share of partnership liabilities at any point in time.

Each partner's share of partnership liabilities depends on the following three factors:

1. Is the liability in question a recourse or nonrecourse liability?
2. If it is a recourse liability, what is each partner's relative economic risk in the worst-case scenario?
3. If it is a nonrecourse liability, what are the precontribution minimum gain, the minimum gain chargeback, and the partners' shares of partnership profits?

In the partnership context a debt is a *recourse liability* when any partner or any person related to any partner bears the economic risk for payment [Treas. Reg. § 1.752-1(a)(1)]. If no partner (or person related to any partner) has personal liability for payment of a partnership debt, it is termed a *partnership nonrecourse liability.*

Partners' Shares of Recourse Liabilities

A partner's share of liabilities for puposes of allocating outside basis among the partners is the partner's share of the hypothetical loss that would be sustained if all of the partnership assets (including cash) immediately became completely worthless. In this "constructive liquidation" the loss must be charged to each partner's capital account. Each partner is then required to contribute cash back to the partnership equal to his or her deficit capital account. Because the entire event is hypothetical, and the outcome is a hypothetical satisfaction of creditors, the loss and capital measures used are book values, rather than tax basis.

This concept is devised for the general partnership, where local law mandates deficit reduction obligations for general partners. However, it also applies to LLCs and limited liability partnerships (LLPs), but only to the extent any member or partner would actually be required to satisfy the entity's creditors. The result of the constructive liquidation test can be overridden by agreements among the partners or members and creditors relating to specific performance obligations in the event of default.

Constructive liquidation is accomplished through the following hypothetical steps:

1. All properties secured by nonrecourse liabilities are sold for the amount of the liabilities. Gain or loss on each of these sales is the difference between the amount of liability owed on each property and the book value of each property.
2. All other properties are sold for zero, and the resulting loss on these properties is the book value on the date of constructive liquidation.
3. Now the partnership has no assets and still has all of its recourse liabilities to pay.

[Treas. Reg. § 1.752-2(b)(2)]

At this point, the obligation of each partner to make payments on partnership liabilities must be taken into account in totality [Treas. Reg. § 1.752-2(b)(3)]. This regulation lists three factors that must be taken into account. Many practitioners consider the second item to be the most important. Partners are obligated to pay on

1. contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, other partners, or the partnership;
2. obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and
3. payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute.

After the economic risk of loss is determined by using a hypothetical "constructive liquidation" or worst-case-scenario analysis, the loss is allocated among the partners in proportion to the relative risk borne by each.

In an LLC there may be no member who has economic risk of loss, because creditors of the business may have no recourse against the members. However, a typical arm's length lending transaction requires the owner or owners of a small business to guarantee payment to the lender. Thus, even with an LLC, the members may have an actual risk of economic loss.

Practitioner Note — Obligation to Restore a Deficit

Many partnership agreements, including those derived from boilerplate language, contain a provision that obligates a partner to restore a deficit in his or her capital account when the person is no longer a partner. This language is often termed a *deficit restoration obligation*, or DRO. A DRO may be necessary to support certain special allocations of gains, losses, income, and deductions that differ from the partners' various interests in the partnership. If these provisions are absent, then the agreement cannot have substantial economic effect. See Treas. Reg. § 1.704-1(b).

If these provisions are incorporated into an LLC's operating agreement, they could erase the statutory protection accorded LLC members from the debts of the business. A creditor whose claims cannot be satisfied by the assets of the LLC may be able to enforce payment by any member who is obligated to contribute money to the entity. Thus, a DRO may have the effect of converting an LLC to a general partnership or a limited partnership with at least one member having unlimited personal liability.

Example 12.7 Equal Allocations of Recourse Liabilities

Allen Cook and Barbara Brown are general partners in the AB Partnership. Each contributed $100 cash. The partnership then borrowed $800, with recourse, and purchased a building for $1,000.

The partnership agreement provides that all items are allocated equally and that capital accounts will be maintained in accordance with the regulations under I.R.C. § 704(b), including a deficit capital account restoration obligation on liquidation. In a constructive liquidation the $800 liability becomes due and payable. All of the partnership's assets, including the building, are deemed to be worthless. The building is deemed sold for a zero value, and the capital accounts are adjusted to reflect the $1,000 book loss on the hypothetical disposition. As shown in **Figure 12.1**, Allen's and Barbara's capital accounts are a negative $400 each, and their outside bases are $500 each.

FIGURE 12.1 Partners' Capital Accounts and Bases: Equal Allocations of Recourse Liabilities

	Capital Account		Outside Basis	
	Allen	Barbara	Allen	Barbara
Initial contribution	$ 100	$ 100	$100	$100
Loss on constructive liquidation	(500)	(500)		
Adjusted capital account	$(400)	$(400)		
Share of partnership liabilities			400	400
Outside basis			$500	$500

Example 12.8 90/10 Allocation of Recourse Liabilities

Assume the same facts as in Example 12.7, except that book and tax losses are allocated 90% to Allen and 10% to Barbara. As shown in **Figure 12.2**, Allen's capital account is adjusted to reflect his $900 loss on the hypothetical disposition, and Barbara's is adjusted by $100. Their capital accounts are negative $800 and zero, respectively.

Because Allen is the only partner who would have a deficit capital account at the time of a constructive liquidation, he bears the entire $800 risk of loss. His outside basis is $900, and Barbara's outside basis is $100.

FIGURE 12.2 Partners' Capital Accounts and Bases: 90/10 Allocation of Recourse Liabilities

	Capital Account		Outside Basis	
	Allen	Barbara	Allen	Barbara
Initial contribution	$ 100	$ 100	$100	$100
Loss on constructive liquidation	(900)	(100)		
Adjusted capital account	$(800)	$ 0		
Share of partnership liabilities			800	0
Outside basis			$900	$100

Observation Inverse Relationship

A partner's capital account balance in essence relieves that partner of part of his or her obligation to make payment on a liability of the partnership. Therefore, there is an inverse relationship between a partner's capital account and that person's share of liabilities.

In some cases an agreement can leave one or more partners with a positive capital account balance. In this situation any partner with a positive capital account after the constructive liquidation becomes a creditor of the partnership, and other partners are obligated to restore capital account deficits accordingly.

Example 12.9 95/5 Allocation of Recourse Liabilities

Assume the same facts as in Example 12.7, except that book and tax losses are specially allocated 95% to Allen and 5% to Barbara. Capital accounts are adjusted to $950 for Allen and $50 for Barbara, resulting in a negative $850 capital account for Allen and $50 for Barbara, as shown in **Figure 12.3.**

Because Allen is the only partner who would have a deficit capital account at the time of a constructive liquidation, Allen bears the entire risk of loss. However, at the moment in time before the constructive liquidation, the total partnership liabilities are $800. Therefore, as in Example 12.8, Allen's outside basis is $900, and Barbara's outside basis is $100.

FIGURE 12.3 Partners' Capital Accounts and Bases: 95/5 Allocation of Recourse Liabilities

	Capital Account		Outside Basis	
	Allen	**Barbara**	**Allen**	**Barbara**
Initial contribution	$ 100	$ 100	$100	$100
Loss on constructive liquidation	(950)	(50)		
Adjusted capital account	$(850)	$ 50		
Share of partnership liabilities			800	0
Outside basis			$900	$100

Adapted from Treas. Reg. § 1.752-2(f), Example 1

The financial condition of any partner is disregarded in making the allocations [Treas. Reg. § 1.752-2(b)(6)]. However, the proposed regulations discussed later might change this rule.

Example 12.10 Financial Condition Disregarded

The facts are the same as in Example 12.8. The possibility that Allen would not have sufficient assets to satisfy the $800 partnership debt, or that he might be forced into bankruptcy in a constructive liquidation, is disregarded.

After the constructive liquidation, the partners must examine any stop-loss agreements or other arrangements outside the partnership. These would include indemnities and other arrangements whereby one person might protect a partner from the economic impact of the entity's debts. Although such agreements might not appear within documents of the partnership or LLC, they are important determinants of each partner's or member's basis. These outside agreements may also change at any time without being recorded in company records. Thus, they should be routine checklist items for the practitioner, as well as one of the issues thoroughly detailed when initializing a tax engagement.

Example 12.11 Agreement between Partners

The facts are the same as in Example 12.8. Assume that Barbara indemnifies Allen so that he will not be required to contribute more than $650 to the partnership under any circumstance. The partners' outside bases would then be $750 and $250, as calculated in **Figure 12.4**.

FIGURE 12.4 Partners' Capital Accounts and Bases: Agreement between Parties

	Capital Account		Outside Basis	
	Allen	Barbara	Allen	Barbara
Initial contribution	$ 100	$ 100	$100	$100
Loss on constructive liquidation	(900)	(100)		
Effect of stop-loss agreement	150	(150)		
Adjusted capital account	$(650)	$(150)		
Share of partnership liabilities			650	150
Outside basis			$750	$250

Overlapping Guarantees: Proposed Regulations

With the proliferation of limited liability entities, many partnerships (including LLCs taxed as partnerships) are formed under state law that gives creditors of the entity no recourse against the owners of the entity. Recourse is therefore determined only by the affirmative guarantee of the various owners. In such situations there may be total guarantees that exceeded 100% of the liabilities. Prop. Treas. Reg. § 1.752-2(a)(2) apportions each owner's individual share as a percentage of the total guarantees of all owners.

Example 12.12 Overlapping Economic Risk of Loss

Abigail Jones and Meaghan Johnson are unrelated and equal members of SIS, LLC. SIS is treated as a partnership for federal tax purposes. SIS borrowed $1,000 from Big Bank. Abigail guaranteed payment for the entire amount of SIS's $1,000 liability, and Meaghan guaranteed payment for $500 of the liability. Both Abigail and Meaghan waive their rights of contribution against each other. SIS's $1,000 increase in liabilities increases Abigail's outside basis by $667 [$1,000 × ($1,000 ÷ $1,500)] and Meaghan's outside basis by $333 [$1,000 × ($500 ÷ $1,500)] [adapted from Prop. Treas. Reg. § 1.752-2(f), Example 9].

Top Dollar and Bottom Dollar Guarantees: Proposed Regulations

Another paragraph of the proposed regulations would change the allocation rules for top dollar (first in line of fire) and bottom dollar (last in line) guarantors. The concern is that current rules allow persons to claim "risk of loss" for arrangements that provide little or no actual economic risk [Prop. Treas. Reg. § 1.752-2(b)(3)].

The regulations, if adopted, would evaluate the extent to which a partner or related person would be obligated to make a payment, depending on the facts and circumstances [Prop. Treas. Reg. § 1.752-2(b)(3)(i)]. The regulation then lists specific facts and circumstances that must be taken into account in determining each partner's risk:

1. Contractual obligations outside the partnership agreement
2. Obligations to the partnership that are imposed by the partnership agreement
3. Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law

Example 12.13 Related Person Guaranteeing Debt

Clyde Smith is the sole shareholder of Bubco, an S corporation. Bubco is a one-third member in AMB, LLC. AMB is treated as a partnership for federal income tax purposes. Bubco does not guarantee any of AMB's debts. However, Clyde guarantees one-third of AMB's liabilities. Therefore, Bubco has economic risk of loss to the extent of Clyde's guarantee.

Prop. Treas. Reg. § 1.752-2 adopts certain recognition requirements for a partner's economic risk to be respected [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)].

To be treated as having economic risk for any guarantee, indemnity, or similar arrangement, the guaranteeing partner must meet all of the first five criteria listed next. If the partner's risk is in the form of a guarantee, the arrangement must meet item 6, but not item 7. If the agreement is an indemnification, reimbursement, or similar arrangement, item 6 is not relevant, but the whole scheme must consider item 7. Items 6 and 7 are especially important, because either one provides traps whereby a partner may lose all economic risk if he or she is not obligated to pay the full amount of the commitment.

1. The partner or related person must maintain a commercially reasonable net worth or be subject to commercially reasonable restrictions on asset transfers [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A)].
2. The partner or related person must provide periodic documentation, such as financial statements, concerning net worth [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(B)].
3. The partner or related person must maintain the liability for as long as the company is obligated on the debt [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(C)].
4. The obligation may not require that the company hold sufficient liquid assets to ensure ability to pay the liability or require that the company hold liquid assets in excess of its reasonable needs [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(D)].
5. The partner must have received arm's length consideration for assuming the obligation [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(E)].
6. In the case of a guarantee, the partner must not be protected from his or her obligation to make payment of the *full amount* of the guarantee by some other person's overriding commitment, except for proportionate contribution obligations by co-obligors [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F)].
7. In case of an indemnity, reimbursement agreement, or similar arrangement, the partner must not be protected from his or her obligation to pay the *full amount* of the indemnity, reimbursement agreement, or similar arrangement, except for proportionate contribution obligations by co-obligors (emphasis ours) [Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(G)].

Observation Partial Indemnification

Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(F) treats a guarantee as a valid addition to basis only if the guarantor has no protection from any part of his or her payment obligation by any other partner. Thus, a guarantee or indemnification between various partners should run from each partner directly to the lender if they want to maintain economic risk for all of the guarantors.

Observation Debt Must Otherwise Be Considered Valid

Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(G) does not allow a person who indemnifies a partner or member to have a superior position. In other words, if one partner guarantees a debt of a partnership but the guarantee does not meet the criteria for economic risk, then the indemnity of this partner by another partner will not create economic risk to the second partner.

Requirements 6 and 7 are cryptic, and refer to some arrangements known as "top dollar," "bottom dollar," and "vertical slice" guarantees. The proposed regulation provides some examples that illustrate the meaning of these items.

Example 12.14 Guarantee of First and Last Dollars

James Green, Evelyn Heller, and Josephine Boyle are equal members of LIT, LLC, that is treated as a partnership for federal tax purposes. LIT borrowed $1,000 from Big Bank. James guaranteed payment of up to $300 of the LIT liability if Big Bank does not recover any of the full $1,000 liability. Evelyn guaranteed payment of up to $200, but only if Big Bank otherwise recovers less than $200. Both James and Evelyn waived their rights of contribution against each other. James's and Evelyn's guarantees satisfy the requirements set forth in items 1 through 5 shown earlier.

Because James is obligated to pay up to $300 if and to the extent that any amount of the $1,000 partnership liability is not recovered by Big Bank, James's guarantee satisfies the item 6 requirement. Therefore, James's payment obligation is recognized. The amount of James's economic risk of loss is $300.

However, because Evelyn is obligated to pay up to $200 only if and to the extent that Big Bank otherwise recovers less than $200 of the $1,000 partnership liability, Evelyn's guarantee does not satisfy the item 6 requirement, because James's guarantee protects Evelyn from any obligation to pay any amount.

Therefore, Evelyn bears no economic risk of loss for LIT's liability. As a result, $300 of the liability is allocated to James, and the remaining $700 liability is treated as a nonrecourse liability because no member has any economic risk. The $700 is allocated to James, Evelyn, and Josephine under Prop. Treas. Reg. § 1.752-3, discussed later in this issue [adapted from Prop. Treas. Reg. § 1.752-2(f), Example 10].

Example 12.15 Indemnification of Guarantees

The facts are the same as in Example 12.14, except that in addition Josephine agreed to indemnify James up to $50 that James pays with respect to his guarantee, and Josephine agreed to indemnify Evelyn fully with respect to her guarantee. Josephine's indemnity satisfies the requirements set forth in items 1 through 5.

The determination of whether Josephine's indemnity satisfies the item 7 requirement is made without regard to whether Josephine's indemnity itself causes James's guarantee not to be recognized. In other words, Josephine's risk is evaluated without regard to the effect it might have on James's risk.

James's obligation would be recognized but for the effect of Josephine's indemnity. Therefore, Josephine is indemnifying an obligation that would be recognized if it were not for her agreement. Thus, Josephine's indemnity of James's guarantee satisfies the item 7 requirement for her. The amount of Josephine's economic risk of loss is $50.

However, Josephine's indemnification causes James to lose *all* of his liability allocation because this arrangement violates item 6. Accordingly, James is treated as having *no* economic risk.

Because Evelyn's obligation is not recognized under items 1 through 5, Josephine's indemnity of Evelyn's guarantee does not satisfy the item 7 requirement. Therefore, Josephine bears no economic risk of loss for her indemnity of Evelyn's guarantee. As a result, $50 of the liability is allocated to Josephine as a recourse liability, and the remaining $950 liability is allocated to James, Evelyn, and Josephine as a nonrecourse liability [adapted from Prop. Treas. Reg. § 1.752-2(f), Example 11].

Example 12.16 Guarantee of Vertical Slice

Floyd Bils and Olive Lutze are equal members of FOL, LLC, which is treated as a partnership for federal tax purposes. FOL, LLC borrowed $1,000 from Big Bank. Floyd guaranteed payment of 25% of each dollar of the $1,000 liability that Big Bank does not recover. Floyd's guarantee satisfies the requirements set forth in items 1 through 5.

Now assume that Big Bank could not recover $250 of the $1,000 LLC liability; Floyd is obligated to pay only $62.50 ($250 × 25%) pursuant to the terms of the guarantee. Because Floyd is not obligated to pay up to the full amount of the LLC's payment obligation ($250) to the extent that Big Bank does not recover $250, Floyd's guarantee does not satisfy the requirement of item 6. Accordingly, Floyd's payment obligation is not recognized. As a result, the entire $1,000 liability is allocated to Floyd and Olive as a nonrecourse liability [adapted from Prop. Treas. Reg. § 1.752-2(f), Example 12].

Practitioner Note Prospective Effective Date

The rules discussed in this text would take effect prospectively only. These rules would apply to liabilities incurred or assumed by a partnership and to payment obligations imposed or undertaken with respect to a partnership liability on or after the date the proposed regulations become final. Tax professionals with partnership clients must be on the alert for any changes in the status of Prop. Treas. Reg. § 1.752-2.

Partners' Shares of Nonrecourse Liabilities

In general, a nonrecourse liability exists when the lender has no recourse against the borrower, except to take possession of property pledged as security for the debt. This type of financing leaves the lender with more risk than does a typical recourse financing arrangement. However, if the lender believes that the property provides sufficient security for repayment of the debt, it might enter into such an arrangement. Typically, a nonrecourse deal involves a greater down payment and higher interest rate than would a recourse financing of a similar property or activity.

Nonrecourse Liability Defined

In the partnership context there are two types of debt that are considered nonrecourse. One is when a lender makes a nonrecourse loan to the partnership. This is generally termed a *partnership nonrecourse liability*. At one time this was popular with real estate partnerships, but market failures and a tightening of lending standards since the 1980s have made this type of arrangement less popular.

The other type of nonrecourse liability is the *partner nonrecourse liability*. In this case the lender advances money to the partnership and requires the entity to guarantee payment unconditionally. From the lender's point of view, this arrangement resembles traditional recourse financing. A partnership or LLC debt is a partner nonrecourse liability only if no partner or person related to any partner bears economic risk for payment. Treas. Reg. § 1.752-4(b) gives a special definition of *related person* for this purpose. If an affiliate of any partner, as well as a family member, has any risk of loss for the debt, it is treated as recourse.

In the context of a traditional "general" partnership or limited partnership, nonrecourse liabilities are limited to partnership nonrecourse liabilities, because one or more of the partners has unlimited liability for repayment of any other type of debt if the partnership is unable to pay. By contrast, an LLC's recourse liability can be a partner nonrecourse liability because members are not liable for LLC debts unless a member guarantees a loan on behalf of the LLC.

In general, a partnership's nonrecourse liabilities are allocated according to profit-sharing ratios. There are other rules for liabilities associated with property contributed by a partner and for liabilities for which depreciated property is pledged as security. See Treas. Reg. § 1.752-3 for discussion of allocation of partnership nonrecourse liabilities.

In some respects it makes sense to classify partnership nonrecourse liabilities into two categories:

1. Liabilities connected with the acquisition or holding of specific properties, in which the property in question is pledged as security for the debt
2. Other liabilities of a partnership that may or may not be secured by specific assets, but for which no partner has economic risk of loss

A debt instrument could be a mix between recourse and nonrecourse. In this situation the members might have personal liability for some but not all of the principal amount of the company's debt. See Examples 12.14, 12.15, and 12.16 for illustrations of this phenomenon. However, none of those examples dealt with the allocation of the nonrecourse portion of the liability in question.

Nonrecourse Liability Associated Directly with Pledged Property

The current regulations issued under subchapter K of the Internal Revenue Code deal very little with partner nonrecourse liabilities. Most of the verbiage and all of the examples describe the allocations of nonrecourse liability that is associated with one or more specific properties that the partnership pledges as security. The regulations generally match the liability to the deductions associated with the property.

The current regulations state three rules for allocating partner nonrecourse liabilities. They are concerned, in part, with the concept of *minimum gain*. Minimum gain occurs because the lender must take back the property in the event of default by the debtor partnership. Thus, the minimum sales price that the current owner of the property can ever realize is the face amount of the nonrecourse liability. In this situation, if the basis of the property to which the liability is subject is less than the amount of the liability, the partnership can always realize a gain merely by transferring the property to the lender, even if the property is worthless.

For any given nonrecourse liability, the ordering is as follows:

1. To the extent basis is less than the liability because of activities such as depreciation that occurred while the partnership held the property, the liability must be allocated according to the allocation of the deductions, such as depreciation, that created the minimum gain [Treas. Reg. § 1.752-3(a)(1)]. This is the *minimum gain chargeback*.
2. If the partnership acquired the property as a contribution from a partner, and the property's basis at the time of contribution was less than the liability, this minimum gain at the time of contribution must be allocated to the contributing partner [Treas. Reg. § 1.752-3(a)(2)]. This is often called the *precontribution gain*.
3. Any nonrecourse liability not within rules 1 and 2 is termed an *excess nonrecourse liability*. The partnership may allocate this to the various partners according to their shares of partnership profits. Alternatively, the partnership may allocate this portion of the liability in proportion to the reasonably expected allocation of deductions (such as depreciation) to the various partners [Treas. Reg. § 1.752-3(a)(3)].

Example 12.17 Nonrecourse Liability Secured by Contributed Property

Alfie Conrad contributed property to ABC Partnership in exchange for a one-third interest. At the time of the contribution, the property's basis was $400,000, and it was subject to a $450,000 nonrecourse liability. Brenda Boxworth and Clarence Hart each contributed cash for one-third interests in the partnership. In the first 2 years of operations, the partnership deducted $60,000 of depreciation and made no principal payments on the note. The partnership allocated the depreciation in equal portions to Alfie, Brenda, and Clyde. After 2 years ABC admitted Della Egan as a one-quarter partner. The allocations of the liability, for inclusion in each partner's basis, are shown in **Figure 12.5**.

FIGURE 12.5 Nonrecourse Liability Securing Property

	Alfie	Brenda	Clarence	Della	Total
1. Minimum gain chargeback	$20,000	$20,000	$20,000	$ 0	$60,000
2. Precontribution gain	50,000	0	0	0	50,000
3. Excess nonrecourse liability	85,000	85,000	85,000	85,000	340,000
Total	$155,000	$105,000	$105,000	$85,000	$450,000

As the partnership pays principal on the note, the minimum gain may decrease. When this happens the reduction of the tier of liability allocation is made in reverse order. Thus, excess partner nonrecourse liabilities are reduced first, the precontribution gain is reduced second, and the minimum gain chargeback is reduced last. Of course, the minimum gain may increase if the partnership continues to depreciate the property faster than it pays principal on the liability. In that case the minimum gain chargeback is adjusted each year and allocated to the various partners in accordance with their profit-sharing ratios.

Nonrecourse Liability Not Associated Directly with Pledged Property

The current Treasury regulations have no allocation rules for partner nonrecourse liabilities other than those discussed previously. Any nonrecourse liabilities that are not allocated according to the minimum gain chargeback or the precontribution gain rules must be governed by the allocation rules for excess partner nonrecourse liabilities, as discussed earlier. The partnership must allocate partner nonrecourse liabilities in accordance with the partners' relative interests in partnership profits.

A proposed amendment to the current regulations would allow a partnership to allocate partner nonrecourse liabilities in proportion to the partners' liquidation percentages [Prop. Treas. Reg. § 1.752-3(a)(3). This would apply to all "excess" partner nonrecourse liabilities, whether or not they are associated with specific items of partnership property. The liquidation percentages are the capital account balances that would occur if the partnership was to sell all of its assets at FMV.

Example 12.18 Liquidation Percentages

On January 1, 2015, Xavier Goldrosen and Yolanda Finch each contributed $100 to XY, an LLC classified as a partnership for federal tax purposes, in exchange for equal interests. XY's organizing agreement provides that it will maintain members' capital accounts in accordance with I.R.C. § 704 and the regulations thereunder, and will make liquidating distributions in accordance with positive capital account balances. XY has a calendar-year tax year. On the day Xavier and Yolanda made their contributions, XY borrowed $50 from a person unrelated to either Xavier or Yolanda. The liability is a nonrecourse liability. XY purchased Land A for $50 and Land B for $200. Xavier and Yolanda agreed to allocate excess nonrecourse liabilities in accordance with the members' liquidation value percentages.

On the day Xavier and Yolanda made their contributions, the liquidation value percentage for each of them is 50% [$100 (each member's liquidation value immediately after the formation) ÷ $200 (XY's aggregate liquidation value immediately after the formation)]. Therefore, Xavier and Yolanda each have a $25 share of the $50 liability, and each is treated as contributing $25 to XY, so each member's basis increases by $25.

In a later year XY has property worth $1,240 and owes $40 on the nonrecourse liability. Thus, the value of each member's capital account is $600 [($1,240 – $40) ÷ 2]. Xavier's portion of the nonrecourse liability is $20, and Yolanda's is also $20.

XY distributed land with a $400 FMV to Xavier and did not make a distribution to Yolanda. As a result, the value of Xavier's capital account decreased to $200, and Yolanda's remained at $600. The liquidation percentages are now 25% to Xavier and 75% to Yolanda. Using the liquidation percentages, Xavier's share of the $40 liability is $10 [$40 × ($200 ÷ $800)], and Yolanda's is $30 [$40 × ($600 ÷ $800)]. The shift in allocation is treated as a distribution of $10 ($20 – $10) from XY to Xavier and a $10 ($30 – $20) contribution by Yolanda to XY [Prop. Treas. Reg. § 1.752-3(c), Example 2].

The amendment was proposed in early 2014 [Preamble to Prop. Regs., 79 F.R. 4826 (January 30, 2014)]. It is the first instance in which the Treasury's liability allocation rules have specifically mentioned LLCs. The amendment refers only to the excess partner nonrecourse liabilities, which are not subject to allocation by the minimum gain chargeback or precontribution gain rule.

Excess Partner Nonrecourse Liabilities

In Examples 12.12, 12.13, and 12.14, some or all of the liabilities were treated as nonrecourse, even though one or more members had guaranteed repayment of the debt to the lender. These examples do not give sufficient information to indicate the LLC's allocation of profits to the various members or the liquidation percentages of each member.

If Prop. Treas. Reg. § 1.752-2 governing the definitions of recourse debt becomes final, the members of these hypothetical entities must determine the allocation of the nonrecourse portion of the liability in question. It appears that each of these liabilities are in the class of excess partner nonrecourse liabilities. Therefore, using the members' interests in profits to allocate the nonrecourse portion of the liability should be an acceptable allocation formula. If Prop. Treas. Reg. § 1.752-3 governing the allocations of nonrecourse debt becomes final, it will also be permissible to allocate the nonrecourse portions of the debts in accordance with each member's liquidation percentage.

ISSUE 3: LIMITED LIABILITY COMPANIES Under the Internal Revenue Code, an LLC may be taxed as corporation, partnership, or disregarded entity.

From its inception the Internal Revenue Code has recognized only two business entities: the partnership [I.R.C. § 7701(a)(2)] and the corporation [I.R.C. § 7701(a)(3)]. There is no separate statutory classification for a business organization that does not fit exactly into one of these two categories. The IRS struggled for years over whether to treat an LLC as a corporation or as a partnership, and generally ruled that the classification depended on the presence or absence of certain corporate attributes.

In late 1996 the IRS adopted a common sense approach to classification of unincorporated entities. The general rule is that an unincorporated entity with more than one owner is treated as a partnership, although it can elect to be treated as a corporation for federal tax purposes. An SMLLC is disregarded entirely as a separate entity unless it elects to be a corporation for federal tax purposes [Treas. Reg. § 301.7701-3(b)(1)]. The election, often referred to as "check the box," is made by filing Form 8832, Entity Classification Election. Once made, an election generally cannot be changed for 60 months.

"Check the Box" Issues

Conversion of an LLC from one entity tax status to another can be complicated. The regulations treat it as an actual conversion from the prior entity. For example, if the LLC was treated as a corporation, it must now simulate a corporate liquidation. The deemed corporation is treated as if it is distributing all of its assets to its members (or a single member) in complete liquidation. This usually results in taxable gains at both the shareholder and corporate levels [I.R.C. §§ 331 and 336].

Observation All Unincorporated Business Entities

The discussion and examples of the "check the box" rules in this material focus on the LLC and its possible tax classifications. However, the same rules for multiple-member entities apply to all domestic unincorporated business enterprises. Thus, partnerships, limited partnerships, limited liability partnerships, and even limited liability limited partnerships may elect to be treated as C corporations or S corporations (if they qualify for S corporation status) using the same rules discussed herein.

Mandatory Change of Default Status

If the LLC had multiple members and now has only one but had not elected to be taxed as a corporation, it must go through the same steps as if it had been a partnership that has just terminated [Treas. Reg. § 301.7701-3(f)(2)]. Two possible transactions may cause this to happen:

1. One of the prior members purchased all of the other prior members' interests.
2. All of the prior members sold their interests to one individual or entity that was not a member before the sale.

The tax treatment of the change in the entity's status depends upon the form of the transaction. If the new sole member was a prior member, the change in entity status is treated as if the parties had engaged in the following transactions:

1. The partnership made a liquidating distribution of all of its assets to all of its members.
2. The continuing member acquired the partnership assets deemed to have been distributed to the selling members.

[Rev. Rul. 99-6, 1999-1 C.B. 432]

Example 12.19 Buyout by Continuing Member

Bob Bunson and Margaret Everard have been equal unrelated owners of Wallabrook, an LLC that owns land and a building that has been depreciated using a straight-line method. Wallabrook has no other assets or liabilities. On April 23, 2015, Margaret bought all of Bob's interest for $150,000, which equaled half the FMV of its assets. The FMV of the land is $100,000, and the LLC's basis in it is $80,000. The FMV of the building is $200,000, and its adjusted basis is $320,000. Thus, the total asset basis is $400,000. To simplify this example, assume that Margaret and Bob each have a $200,000 outside basis in their interest in Wallabrook.

When Margaret bought the entire interest, Bob is treated as if he sold his interest in the LLC for $150,000, and he recognizes a $50,000 ($150,000 – $200,000) loss. In this situation all of his $50,000 loss is capital loss.

Margaret is treated as if the following transactions occurred:

1. The LLC made a hypothetical liquidating distribution of all of its assets in proportion to each member's interest immediately before the actual sale. Each member is deemed to receive the assets as a distribution from the partnership. Each member assigns his or her prior $200,000 outside basis to the properties received to the extent of the partnership's basis in those assets. In this case the sum of members' outside bases equals the sum of the partnership's bases in the assets, so there is no further allocation of the members' outside bases. Each member allocates $40,000 of his or her outside basis to the land and $160,000 of basis to the building.
2. Margaret purchased Bob's portion of the land and building from him, and she takes the purchase price of each of his interests as her basis in that portion. Thus, Margaret's total basis in the land and building is calculated as shown in **Figure 12.6**.

Margaret must treat each portion of the property as a separate property. For depreciation on the building, she will treat one-half of the basis as if she had received it as a distribution from a partnership, and she will treat the other half as newly purchased property [Rev. Rul. 99-6, Situation 1]. She also carries over the prior holding period for the assets she is deemed to receive as a distribution [I.R.C. § 1223(2)], whereas the holding period for the assets deemed purchased begins anew.

FIGURE 12.6 Margaret's Basis in Assets

Asset	Purchased Basis	Carryover Basis	Total
Land	$ 50,000	$ 40,000	$ 90,000
Building	100,000	160,000	260,000
Total	$150,000	$200,000	$350,000

The second transaction in which a multiple-member LLC becomes a single-member LLC is when all of the prior owners sell their interests simultaneously. In this case the new owner is treated as having purchased the assets directly from the entity [Rev. Rul. 99-6, Situation 2].

Example 12.20 Buyout by Nonmember

Assume the same facts as in Example 12.19 except that Margaret and Bob both sell their entire interests in Wallabrook to John Jacobson for $150,000 each. Each recognizes the same $50,000 loss that Bob did in Example 12.19.

At the moment of sale, Wallabrook becomes an SMLLC, and all of its property is treated as owned by John for federal income tax purposes. John's basis is the $300,000 he paid to the two selling members. The allocation of the purchase price should follow the residual method of I.R.C. § 1060 if Wallabrook's activity is a trade or business to which goodwill or going concern value attaches [Treas. Reg. § 1.1060-1(b)(2)].

Effect of Passive Activity Losses

When one or more of the selling members in the LLC has been subject to passive activity loss limits and has suspended losses in connection with the LLC's business or rental activity, there can be some strange gaps in the tax law. If the buyer is unrelated to the selling member, and the selling member retains no interest in the activity conducted by the LLC, the sale qualifies as a complete disposition of the taxpayer's interest in the activity. However, there can be some complications in other situations.

First, if the seller recognizes gain, the gain is treated as passive activity gross income [Temp. Treas. Reg. § 1.469-2T(c)(2)(i)]. To the extent this gain exceeds the suspended losses connected with this particular activity, it is available to offset any other passive losses of the selling member. However, if the suspended losses exceed the gain, the taxpayer may nevertheless claim the losses because there is a complete disposition of the interest in the activity to an unrelated party [I.R.C. § 469(g)].

Second, if the seller recognizes gain and the transaction qualifies for installment sale treatment, the suspended loss is prorated and recognized in the same proportions as the gain reported each year [I.R.C. § 469(g)(3)]. If a taxpayer dies without having used all of his or her suspended losses, such losses may be claimed on the decedent's final return, at least in part. The losses are disallowed permanently to the extent the estate or other successor's basis exceeds that of the decedent immediately before death [I.R.C. § 469(g)(2)].

Related Party Issues

When there is a complete disposition of a taxpayer's interest in an activity, but the disposition is made to a related party, there are some other tax issues.

First, any loss sustained on the sale is disallowed to the seller [I.R.C. § 267(a)(1)]. Instead, this loss attaches to the sold property and is allowable to the purchaser as an offset to any gain recognized on a later sale [I.R.C. § 267(d)]. Second, if the seller has suspended passive activity losses, the seller cannot use the suspended losses under the complete disposition rule. Instead, they are not allowable in their entirety until the related party purchaser sells all of the interest in the activity to an unrelated party [I.R.C. § 469(g)(1)(B)]. At that point the suspended passive activity losses are available to offset future passive activity income of the seller. If they are not allowed during the seller's lifetime, they will be allowable, along with other suspended passive activity losses, on the final return.

There are some ambiguities in the law that may cause some confusion. When a multiple-member LLC becomes a single-member LLC, the selling members sell their interests in the company. However, for tax purposes the buyer does not acquire the interests from the sellers, but acquires the assets directly from the company. Thus, there is a break in the chain of ownership when the seller and buyer are related.

Example 12.21 Disposition of Interest in LLC to Related Party

The facts are the same as in Example 12.20, except that Margaret and John are brother and sister. Bob is not related to John, within the meaning of I.R.C. § 267. Bob claims his $50,000 capital loss on the sale of his interest in Wallabrook and is able to use any suspended losses from Wallabrook's activities that he had not already been able to deduct.

However, Margaret is in a different situation. She cannot claim the $50,000 capital loss on the sale at any time because she is related to John. Moreover, she cannot claim any suspended losses from the passive activity loss limits in the year of sale, except to the extent she has passive activity income from other activities.

What happens to the disallowed capital loss on the sale is not entirely clear from the statutes and regulations. The general rule is that such a loss now attaches to the property and is available to offset gain by the purchaser on a subsequent sale. However, Margaret sold an interest in an LCC, while John purchased land and a building.

Similarly, any suspended passive activity loss deduction of Margaret's would be allowable when John disposes of his interest in the activity to an unrelated person. However, the tax law now pretends that John purchased assets, rather than the interest in the activity.

Practitioner Note Sale of Interest to Related Party

The disjointed treatment of buyer and seller when a multiple-member LLC becomes a single-member LLC may give one pause when the deal is between related parties. Although there are no statutes, regulations, rulings, or cases that directly address this issue, it is probably a safe assumption that the related buyer continues to hold the same property sold by the related seller, with respect to the disallowed losses on sale, and any prior disallowed passive activity losses.

No Automatic Change of Elected Status

Once a single-member LLC or multiple-member LLC has elected to be treated as a corporation, it must retain that election until there is a proper revocation [Treas. Reg. § 301.7701-3(a)]. An entity that has changed from the default status to corporate status cannot change back to its default status until the election has been in effect for at least 60 months [Treas. Reg. § 301.7701-3(c)(iv)]. However, this restriction does not apply to an entity that elected corporate status on the date of its formation as a legal entity [Treas. Reg. § 301.7701-3(c)(iv), last sentence].

Example 12.22 Initial Election vs. Change of Status

MJ, LLC and EL, LLC are both domestic SMLLCs. MJ was chartered by the state on February 17, 2011, and operated as a disregarded entity until April 1, 2012, when it elected to become a corporation via Treas. Reg. § 301.7701-3. EL was chartered on April 1, 2012, and elected to be treated as a corporation from that date forward. Thus, MJ and EL, neither of which is incorporated, have both been treated as corporations since April 1, 2012. MJ cannot change its classification back to unincorporated status before April 1, 2017, unless it receives specific permission from the IRS. EL can elect unincorporated status at any time without permission from the IRS because its corporation election has been in effect for its entire existence.

EL elects to become a disregarded entity on October 7, 2014, when it has only one member. EL cannot elect to be taxed as a corporation using the "check the box" regulation before October 7, 2019. However, if one or more new members acquire EL so that it is no longer an SMLLC, it becomes a partnership automatically on the date it had multiple members.

The IRS may grant permission for change in elective status for an unincorporated entity if there has been an ownership change. The change must result in more than 50% of the ownership held by persons who were not members at the time of the prior election [Treas. Reg. § 301.7701-3(c)(iv)].

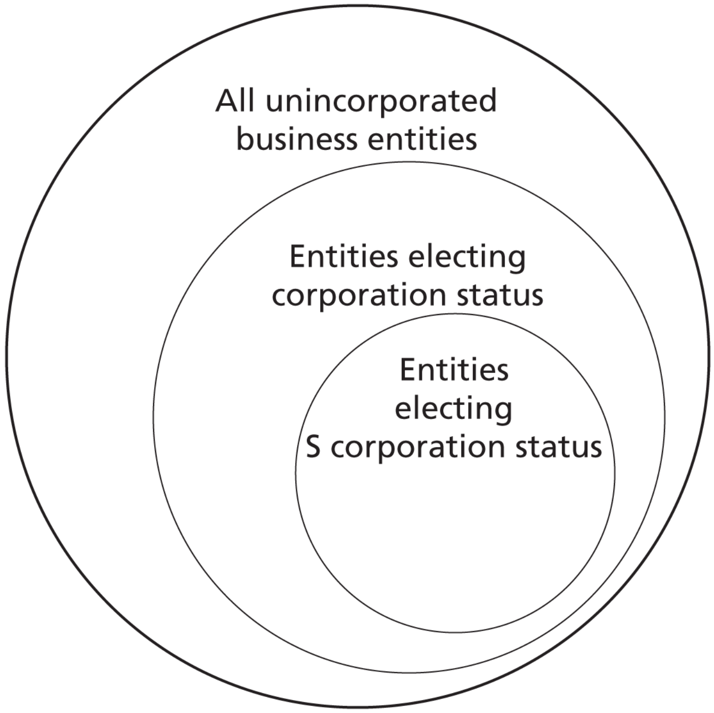
S Corporation or C Corporation

When an LLC or partnership elects to be taxed as a corporation, it falls within the entire set of tax laws applicable to corporations. Thus, the owner or owners are now treated as shareholders for tax purposes. Owners who provide services and receive compensation must treat this arrangement as an employer-employee relationship and follow all federal FICA rules. However, state laws may not entirely conform to this treatment and may or may not impose unemployment taxes.

For all other dealings, such as those concerned with corporate capital transactions, the entity is now treated as a corporation for federal income tax purposes, and all of its owners, present and future, are treated as shareholders. Thus, it must now be consistent with one of the recognizable corporate forms, such as C corporation, S corporation, qualified real esate investment trust (REIT), subsidiary, qualified subchapter S subsidiary, member of a consolidated group of corporations, and the like. In most cases a stand-alone corporation is either a C corporation or an S corporation, and the remainder of this discussion focuses on those two corporate options. **Figure 12.7** providers a simple Venn diagram to illustrate the relationships between the unincorporated entity and its status as an S corporation.

The outer circle (with the heaviest line) represents the entire population of unincorporated entities, whether they be single-member LLCs, multiple-member LLCs, or any of the various types of partnerships that could be eligible for the entity classification election. To break out of this outer circle, there must be a dissolution or incorporation of the entity. A change from one to multiple members or vice versa does not move an entity into or out of this outer circle.

FIGURE 12.7 Overview of Unincorporated Entity and Corporate Elections



The second circle is the corporation election set. Any domestic unincorporated entity can elect to be within this group, unless it has changed its classification within the past 60 months.

The innermost circle, with the lightest line, represents the S corporation. To be within this set of entities, the company in question must be unincorporated, must qualify for the corporation election, and must meet the S corporation qualifications and election procedures. In brief, to qualify for the S corporation election, the entity must have no more than 100 owners (with liberal family attribution rules) and must have no owner who is not: a US citizen or resident, an estate, one of the few types of qualified trusts, or an exempt organization. It must also file Form 2553, Election by a Small Business Corporation, to be an S corporation for tax purposes.

When an entity loses its qualification as an S corporation or elects to revoke S corporation status, it is still within the second circle. Only if it is able to elect out of its corporate classification does it revert to the default treatment as a disregarded entity or a partnership.

Observation Limited Applicability

Figure 12.7 represents only the relationship between unincorporated domestic business entities and the elections to be C or S corporations. It does not include any nonbusiness entities, such as trusts or estates. It does not portray rules applicable to foreign entities. Moreover, it has no representation of scale or the number of entities in each category. If it were drawn to scale, the outer circle would be enormous in comparison to those inside.

Filing Form 2553 to Elect S Corporation Status

An LLC electing S corporation status must file Form 2553, Election by a Small Business Corporation, with the IRS center (Cincinnati or Ogden) where the company files (or will file) its tax returns. Form 2553 is due by the fifteenth day of the third month of the tax year for which it is to take effect. If the company is in existence as a C corporation, it may file this election in the tax year before it intends the status to be effective.

If an LLC filed Form 8832 and claimed C corporation status in a prior year, it may file Form

2553 separately to switch to S corporation status. If the company is electing S corporation status as of the first day it is seeking entity classification as a corporation, it must file Form 2553 as the entity classification election. The company does not file Form 8832 in addition to Form 2553 [Treas. Reg. § 301.7701-3 (c)(1)(v)(C)].

Practitioner Note Attaching Form 8832 to Form 2553

Some tax professionals prefer to file Form 8832 as an attachment to Form 2553 when an entity is seeking to convert from unincorporated tax status to S corporation tax status. There may be instances in which this redundant filing helps the IRS keep track of the history of the returns filed using the same EIN. Moreover, filling out Form 8832 may give more direct answers to ownership questions.

Example 12.23 Disqualification from S Corporation Status

Jack Haggard, an attorney, contributes the assets of his law practice to Jacklaw, LLC, a single-member LLC. In order to gain more leverage in international trade deals, he wants to admit partners (members) from Canada and Mexico. If Jacklaw has not elected to be a corporation via the "check the box" regulation, the admission of new members will cause the entity to become a partnership for federal income tax purposes because it is then a multiple-member LLC. The new members, as non-US citizens or residents, are not eligible S corporation shareholders.

Now assume that Jack had decided to limit his exposure to FICA taxes, and elected to treat Jacklaw as an S corporation for federal income tax purposes, while retaining its nontax LLC status. Admission of new members will not affect its classification as a corporation. Now Jack must time the entity classification change so that it takes effect immediately before the admission of new members, and then Jacklaw will become a C corporation for federal income tax purposes. If Jacklaw has not held corporate classification for at least 60 months, there is no way to avoid this outcome, because the Canadian and Mexican owners render Jacklaw ineligible for S corporation status.

After Jacklaw becomes a C corporation, converting it back to partnership status is a taxable liquidation. Accordingly, the corporation recognizes gains and losses on the distribution of its assets, including goodwill and other intangibles. The shareholders turned partners must also recognize gain on the deemed receipt of the assets from the corporation.

LLC Filing Form W-9

If an LLC receives money from another entity, it may be asked to file a Form W-9, Request for a Taxpayer Identification Number and Certification. Because an LLC has no unique tax status, it must be careful in selecting the proper status on this form.

Backup withholding may be required at a rate of 28% if the recipient/payee fails to provide a taxpayer identification number (TIN), such as a social security number (SSN) or employer identification number (EIN), to the payer, or if the information is incorrect and the IRS notifies the payer. The payer of dividends or interest must withhold taxes from the payments if the IRS notifies the payer that the taxpayer underreported payments, or the taxpayer fails to certify that it is not subject to backup withholding.

Form W-9 provides a payer such as a vendor evidence that a person is not subject to backup withholding or Foreign Account Tax Compliance Act (FATCA) reporting.

If the LLC is a disregarded entity owned by an individual, the form should list both the individual's name and the disregarded entity name. The form can list either the disregarded entity's EIN or the proprietor/member's SSN. The IRS prefers the individual's SSN.

If the LLC is a partnership, C corporation, or S corporation for federal income tax purposes, it should check "LLC" and then enter the appropriate tax classification.

Issuing Form 1099 to an LLC

In general, payments of interest, dividends, or certain other items require filing Form 1099 if the payments are made in the course of the payer's trade or business. The payer files one copy of this form with the IRS and issues another copy to the recipient. Certain recipients are exempt.

Included in exempt status are corporations; tax-exempt organizations; pension trusts; the federal government; and any political subdivision, such as a state. Partnerships and individuals are not exempt [Treas. Reg. § 1.6041-3].

Again there is the question of the status of an LLC for purposes of Form 1099 reporting. In general, the payer must file Form 1099 for the LLC unless the LLC is a corporation [C.C.A. 2014-47-025 (June 19, 2014)]. Accordingly, any business taxpayer that makes reportable payments to an entity identified as an LLC should ask the LLC to provide Form W-9. If the Form W-9 shows that the LLC is taxed as a partnership, the payer should file the appropriate Form 1099 to report such payments. If the payer does not receive a Form W-9 from a payee LLC, it should file the appropriate Form 1099 as if the LLC is not taxed as a corporation.

LLC Members and Self-Employment Tax

Self-employment (SE) income includes income from a trade or business of an individual or a partnership, except for the following:

1. Rents (unless services are significant) [I.R.C. § 1402(a)(1); *Bobo v. Commissioner*, 70 T.C. 706 (1978)]
2. Dividends and interest [I.R.C. § 1402(a)(2)]
3. Capital gains and losses [I.R.C. § 1402(a)(3)(A)]
4. Gains and losses from the sale of other property, except for property held for sale in the ordinary course of business [I.R.C. § 1402(a)(3)(C)]
5. Several other items listed in I.R.C. § 1402(a) not generally relevant to partnerships

Self-Employment Income of a Partner

For a general partner, SE income includes each partner's share of the partnership's trade or business income [I.R.C. § 1402(a)]. It also includes each partner's guaranteed payments for services or capital [Treas. Reg. § 1.1402(a)-1(b)].

Before 1977 limited partners included their shares of partnership income as SE income. This rule allowed limited partners to use investment income to gain social security coverage. To put a stop to that practice, Congress added I.R.C. § 1402(a)(13), which provides the following:

- In general, a limited partner's share of partnership income is not SE income.
- If a limited partner receives a guaranteed payment for services performed to the partnership, the guaranteed payment is SE income.

Uncertainty for Members of LLCs

Members in LLCs face some uncertainty. They are not defined in the Internal Revenue Code as a general partner *or* as a limited partner.

In Rev. Proc. 89-12, 1989-1 C.B. 798, the IRS defined a general partner as one who has management rights. Therefore, the IRS does not view the presence or absence of personal liability for partnership debts as evidence of whether a partner is considered general or limited. As a consequence, it seems possible that a member in an LLC could be either a general partner or a limited partner for purposes of SE income. Under this rationale a member's share of income from a limited liability company could be SE income if the member had management rights.

The IRS has had some difficulty with this gray area. In 1994 proposed regulations would have relied on state law characteristics to determine the general partner or limited partner equivalence. In 1997, however, the 1994 proposed regulations were withdrawn and were replaced by new proposed regulations. The following discussion is based on proposed amendments to Treas. Reg. § 1.1402(a)-2 released on January 13, 1997.

The 1997 amendments to the regulations did not provide a separate categorization scheme for members of LLCs. Instead, the IRS proposed new definitions for all partnerships, including LLCs. Thus, the title of the person under state law or the operating agreement would not be determinative. An LLC member may be a "general partner," who is subject to the SE tax, or a "limited partner," who is not subject to the SE tax.

The 1997 proposed rules would be uniform among the states and would not rely on state law definitions. Under the 1997 rules a partner in a partnership, or a member of an LLC, would be treated as a limited partner unless that person meets any one of three conditions:

1. He or she has unlimited personal liability for the company's debts, by virtue of being a partner [Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(i)]. This situation should rarely, if ever, arise for a member of an LLC.
2. He or she has authority under the law to contract on behalf of the organization [Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(ii) (1997)]. This condition may be conferred by state law or by the operating agreement adopted by the members. It is likely to occur in many LLCs.
3. He or she participates in the trade or business activities of the company for more than 500 hours in the taxable year under question [Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(iii)]. Obviously, this condition will apply to certain persons and not to others.

There are certain exceptions within the rules. For example, any member of a partnership or LLC that provides services as the predominant part of its trade or business is treated as a general partner, and is thus subject to the SE tax [Prop. Treas. Reg. § 1.1402(a)-2(h)(5)]. Thus, any member of a law firm, accounting firm, or other professional service firm would be subject to the SE tax on his or her portion of the income from the business.

There are also special rules for fragmenting interests when a person holds both a limited and a general interest in the same partnership. To be treated as a limited partnership interest, there must be a calculated return on investment capital.

Observation Congressionally Mandated Stalemate

In the Balanced Budget Act of 1997, Pub. L. No. 105-33, the Senate expressed its displeasure with the 1997 proposed regulations defining limited partners. It stated that this task should be accomplished by the legislature. The conference committee directed the IRS not to issue any regulations on this matter before July 1, 1998 [§ 734 of the Senate amendment to H.R. 2014]. As of 2015, neither the IRS nor Congress has taken any further action on this matter. However, the proposed regulation amendments are substantial authority, and will protect taxpayers and preparers from the I.R.C. § 6662 substantial underpayment penalty.

Partners in Limited Liability Partnerships

In many respects LLCs and limited liability partnerships (LLPs) are similar. Both shield all members from unlimited recourse for liabilities of the enterprise. Both allow members to have management interests and investor interests. Thus, an important case in the LLP area has significant implications for LLCs and their members.

In 2011 the Tax Court addressed the problem of fragmentation of interests in an LLP. The case of *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), involved a law firm that had fragmented interests. Three attorney partners had established an aggressive tax structure for their law firm. In 2004 the three attorneys had an employee stock option (ESOP)-owned S corporation as a fourth partner and allocated 87.557% of the income to the S corporation. In 2005, when closely held ESOP-owned S corporations were no longer viable, they restructured the partnership so that each partner held a 1% voting interest and a 32% nonvoting interest, with a view to treating the nonvoting interests as limited partner interests.

The court invalidated the 2004 arrangement because the arrangement was not in accordance with each person's interest in the partnership. Next the court turned to the SE tax issue. The court pointed out that the purpose of the limited partner treatment was to prevent persons from funding their social security benefits by treating investment income as SE income.

However, in this case the opinion states, "Plaintiffs are not members of a limited partnership, nor do they resemble limited partners, which are those who 'lack management powers but enjoy immunity from liability for debts of the partnership.'" Accordingly, the scheme failed, and all of the income resulting from the law practice was treated as SE income.

A 2012 case involved a husband-and-wife-owned LLC. They attempted to limit their SE income by having the company issue Forms W-2 to each, so that they could claim they were not self-employed. However, the court made short work of this approach, stating that none of the income should have been treated as wages or salary, and all should be treated as SE income [*Riether v. United States*, 919 F.Supp.2d 1140 (D. N.M. 2012)].

More recently, IRS chief counsel concluded that so-called limited partners of an investment management firm were not limited partners. The IRS reasoned that the facts were similar to those in the *Renkemeyer* case, and did not treat any of the active managers' interests as limited partnership shares [C.C.A. 2014-36-049 (May 20, 2014)].

LLCs and I.R.C. § 179

The section 179 deduction is a popular election for increasing the net present value of deductions and thus deferring taxable income. For tax years beginning in 2011–2014 Congress temporarily increased the $25,000 limit and the $200,000 beginning of the phaseout of that limit each year to $500,000 and $2,000,000 respectively.

Cross-Reference Section 179 Deduction Rules

See pages 216–220 in the *2012 National Income Tax Workbook* for a detailed discussion of the section 179 deduction before the changes contained in the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, and subsequent legislation.

Application of the Limits

There are some special rules regarding this deduction that affect LLCs and their members. If the LLC is treated as a partnership, the limit applies to both the entity and each member [Treas. Reg. § 1.179-2(c)(2); *Hayden v. Commissioner*, 204 F.3d 772 (7th Cir. 2000)]. This can cause a trap if one person is a member of several partnerships and the section 179 deductions allocated exceed the person's statutory limit.

Example 12.24 Limits of I.R.C. § 179

In 2014 (when the section 179 deduction limit was $500,000), Caroline owned a 40% interest in three different partnerships. Each of the three partnerships was able to elect to deduct $500,000 under I.R.C. § 179, and each allocated $200,000 to Caroline. As a result, Caroline received $600,000 of section 179 deductions. She could deduct only $500,000 due to the statutory limit. However, she must reduce her basis in each of the three partnerships by $200,000. Unlike the taxable income limit, there is no carryover of the excess allowance in this case. Accordingly, she suffers a permanent loss of $100,000 of tax benefit.

This example illustrates the importance of each pass-through entity knowing its members' situations. The same rule applies to S corporations and their shareholders.

Electing Out of Partnership Status

In some situations the partnership limits can constrict each member's ability to use the maximum section 179 deduction. It may be possible for certain ventures to elect out of partnership status and treat the entity's assets as jointly owned property [I.R.C. § 761]. In order to do this, the entity must use the property solely for the benefit of its members and must not deal with any outsiders. The members elect to treat the entity as a nonentity for tax purposes.

Example 12.25 Electing out of Partnership Status to Maximize Section 179 Deductions

In 2014 Greg Ford, Guido Carter, and Claire Ambrosius own adjacent farms. They decided to cooperate on their harvesting operations. For nontax liability purposes they form GGC, LLC, whose sole purpose is to hold title to farm equipment. The three members agree that they will each pay property taxes, insurance, maintenance, repairs, and any other necessary operating costs according to hourly usage of the equipment, but that the ownership shall be in three equal portions. In 2014 GGC bought $1,200,000 of equipment. If GGC is a partnership for federal income tax purposes, it may claim only $500,000 under I.R.C. § 179. If the members are able to treat the venture as a co-ownership arrangement, then each will receive $400,000 of the aggregate purchase price. Each can elect his or her own depreciation methods, including I.R.C. § 179.

The election out of partnership status is available in only three situations. The entity must be one of the following [I.R.C. § 761(a)]:

1. For investment purposes only and not for the active conduct of a business
2. For the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted

3. For the purpose of underwriting, selling, or distributing a particular issue of securities in the case of dealers in short-term securities

The venture may file a partnership return for the first year of its existence and attach a statement that it is electing out of partnership status [Treas. Reg. § 1.761-2(b)(2)(i)]. It may also qualify if it does not file a formal election but the facts and circumstances indicate that this was the intention of the members from inception of the venture [Treas. Reg. § 1.761-2(b)(2)(ii)].

I.R.C. § 179 Noncorporate Lessor Rules

Another quirk of I.R.C. § 179 is its limitation on leased property. For a taxpayer other than a C corporation, property held for rent to others does not qualify for the I.R.C. § 179 allowance unless it meets either of the following conditions:

1. The owner/lessor has manufactured or produced the property [I.R.C. § 179(d)(5)(A)].
2. The lease is relatively short-term, and the owner/lessor incurs substantial expenses (other than taxes, interest, and depreciation) with respect to the property [I.R.C. § 179(d)(5)(B)].

To meet the second criterion, the lease term including options to renew must be less than 50% of the property's class life. The out-of-pocket expenses connected with this property must exceed 15% of the income produced by the property in the first 12 months after the lessee takes possession.

In the case of *Thomann v. Commissioner*, T.C. Memo. 2010-241, the owner of some farmland and equipment entered into an oral lease agreement with a wholly owned corporation. The corporation used a portion of the farmland and certain items of equipment. The farmer, an individual, attempted to claim section 179 deductions for the equipment used by the corporation. The owner claimed that the lease terms were year-by-year. However, the parties produced no evidence of any written arrangement, so the IRS disallowed the deduction. The Tax Court upheld the disallowance, and stated that it did not need to consider the expenses associated with the purportedly leased assets because the lease term violated the conditions of the deduction.

ISSUE 4: SERIES LIMITED LIABILITY COMPANIES

Several states permit a limited liability company to establish subunits. Each of these subunits is termed a *series*. In several jurisdictions each series is protected from claims again the other series within the parent LLC.

Throughout the modern commercial era, investors in the United States and other western nations have employed the corporate entity as protection from personal liability for business obligations. Multiple entities are often created to protect segments of the overall business from claims against other components. Traditionally, these have involved parent-subsidiary or brother-sister groups.

With the growth in LLCs since the mid-1990s, similar structures have evolved for this popular entity choice. Although the parent LLC has served to protect outside investors from business debts, many businesses have sought to further isolate potential liabilities.

Example 12.26 Multiple Subsidiaries

Manyprops, LLC has 150 investors and owns 15 real estate operations in the metropolitan Bigcity area. Manyprops owns and manages shopping centers and apartments and develops residential subdivisions. Manyprops plans to establish an SMLLC for each property owned or being developed to protect the central business from possible claims that could arise against any one of its properties.

Each SMLLC owns a single asset. Although Manyprops guarantees some or all of the debts of the lower-tier entities, its liability is limited to the amount of the guarantee. So if a catastrophic event affects one property, Manyprops's other investments will be protected.

As Example 12.26 indicates, the organization is similar to a parent-subsidiary corporation structure with respect to liability protection. However, in most cases there is only a single level of taxation because the parent organization is treated as a partnership for federal income tax purposes, and the subsidiaries are disregarded entities [Treas. Reg. § 301-7701-3]. (There could be exceptions, such as if the parent or some of the subsidiaries were foreign entities, or if any of the entities had elected to be treated as corporations for tax purposes. However, those are unusual circumstances.)

As an alternative to using subsidiary SMLLCs, some states have enacted statutes permitting the *series LLC*, to facilitate liability segregation and certain other objectives.

Example 12.27 Simplified Series LLC Illustrated

In certain states Manyprops, LLC from Example 12.26 might be able to adopt a more streamlined entity than a parent LLC with multiple subsidiary LLCs. Manyprops, LLC's charter would include the right to establish one or more series LLCs. It then would be able to set up one series for each investment property. If state law permits, each series would be insulated from the liabilities of the other series. Each series would own its property and would be responsible for the debts associated with the property and the operation of its own business. It would not be necessary to work with the state to secure a new charter for each series because Manyprops's own charter gives it the right to form each series.

Another aspect of the series LLC is that it need not allocate all of the income from each series identically. In other words, members' percentage interests in the profits and other tax attributes may differ among the various series.

Example 12.28 Varying Allocation of Each Series's Income

Manyprops from Example 12.27 may be able to vary members' allocation of profits and other tax items for each series. In essence, the profit-sharing arrangement would resemble a group of partnerships whose members differed in percentage ownership of each entity.

Practitioner Note Limitations of the Series LLC

- The series LLC business form has been in existence for nearly 20 years, since Delaware first permitted this structure in 1996. Some other states provide for these charters, but others do not. Unsurprisingly, there can be extreme complexity involved when there are multistate operations or investors. Among the problems are that not all states permit the insulation of each series's liabilities.
- Some states require each series to file separate tax returns, whereas others require only the parent LLC to file a tax return.

The IRS has been largely silent on the treatment of a series LLC and each series thereof. In two situations involving an insurance company and a regulated investment company (RIC), the IRS ruled that each series was treated as a separate partnership for purposes of federal income tax reporting [Ltr. Rul. 2008-03-004 (October 15, 2007); Ltr. Rul. 2015-14-003 (November 24, 2014)].

The apparent rationale for the Delaware statute was to provide a structure for mutual funds and hedge funds to segregate assets, liabilities, and ownership interests among various classes of investors. Thus, these funds can allocate different types of income to US individuals, US governmental units, tax-exempt entities, foreign individuals, foreign corporations, and foreign governments, to name a few. Presumably, these enterprises have sophisticated tax departments to comply with the rules of the United States, US states and localities, and foreign governments. Except for a few intrastate real estate and investment companies, the series LLC structure has limited applicability to closely held businesses and independent tax practitioners.

ISSUE 5: ACCIDENTAL PARTNERSHIPS State laws and the Internal Revenue Code are extremely flexible and informal regarding the establishment of a partnership.

I.R.C. § 7701(a)(2) defines *partnership* and *partner*. This provision states,

> The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

While some may laud its simplicity, this broad definition certainly has its drawbacks. A person may find himself or herself bound by the business actions of another person under local partnership statutes, merely because the two are doing business together.

From a federal income tax point of view, there can also be some unpleasant surprises. Unless the venture qualifies for electing out of partnership status (discussed earlier as part of Issue 4), the persons involved may find themselves subject to audit for failure to file partnership returns, make proper tax elections, and other similar matters.

Under current law the penalty for failure to file Form 1065, U.S. Return of Partnership Income, is $195 per month multiplied by the number of Schedules K-1 (Form 1065) the partnership should have issued. The maximum number of months penalized for any given year is 12, so the maximum penalty is $2,340 per partner ($195 × 12) [I.R.C. § 6698(b)]. After 2014 the amount is indexed for inflation [I.R.C. § 6698(e)].

Example 12.29 Informal Partnership

Les Care is a used car salesman, and E.Z. Going is a mechanic. As a side venture, Les buys automobiles in need of repair, E.Z. makes them roadworthy, and then Les sells them. They buy, repair, and sell about one car per month. They did not get a business charter and did not adopt a "doing business as" name. They keep no formal books and records, other than totaling the profit for each vehicle.

Three years into this side venture, the IRS examined Les's Form 1040, U.S. Individual Income Tax Return, and looked into some of the bank deposits from the car sales. It determined that a partnership has existed for 3 years, and the partnership is liable for penalties for failure to file tax returns. Essentially, the IRS now has the power to recast all of the transactions that have been reported, or should have been reported, by both Les and E.Z. on their tax returns. The penalty is $2,340 per partner for at least 2 years.

ISSUE 6: COMPENSATION OF BUSINESS OWNERS The IRS monitors compensation of business owners to prevent unwarranted reduction of tax liability.

The relationships between closely held businesses and their owners place compensation arrangements under special scrutiny from the IRS. The lack of arm's length negotiations makes it difficult to separate the value of the service provided by owners and their families from the profits of the businesses. Problem areas depend upon the structure of the business, employment of the owner, and other factors such as employment of close friends or family of the owner.

There are numerous cases dealing with compensation for employment in closely held businesses. In some cases the IRS claims the compensation is excessive. In others the IRS argues that the compensation is insufficient. When the IRS asserts that compensation is excessive, the objective is to limit the deduction by the payer. There are two contexts in which this is an issue:

1. The payer is a C corporation and is attempting to mask dividends as deductible payments to a controlling shareholder.
2. The payer is any entity and is attempting to shift taxable income to family members.

Typically, the reverse situation, where the IRS is attempting to increase the amount of reported compensation, involves one of two scenarios:

1. A family member is using a partnership or S corporation to shift income to lower-bracket persons, typically children.
2. A shareholder in an S corporation is attempting to avoid FICA tax by characterizing compensation as a distribution from the corporation.

There has been little litigation on the first problem, but extensive litigation on the second.

Compensation of Partners and LLC Members

Most of the compensation controversies involve C and S corporations. However, there are occasional partnership problems in this area. The Tax Court has held that a guaranteed payment to a partner is also subject to the same tests. Thus, where a partnership was unable to substantiate the services performed, the deduction for a guaranteed payment has been disallowed [*River City Ranches #4 J.V. v. Commissioner*, T.C. Memo. 1999-209].

There is also occasional dispute regarding family partnerships. See the discussion under "Family Partnerships and S Corporations" later in this issue.

More recently there have been issues regarding limited liability partnerships (LLPs) and limited liability companies (LLCs) in the context of self-employment income. See the discussion in Issue 3 in this chapter under the heading "LLC Members and Self-Employment Tax."

Excessive Compensation of C Corporation Shareholders

I.R.C. § 162(a)(1) allows a deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered." Because no statute can define what is reasonable under all circumstances, this matter can be subject to challenge by the IRS. Challenges are rare if the level of compensation is determined by an arm's length agreement. Even the extremely high pay of some athletes is not usually subject to challenge by the IRS because these contracts are carefully negotiated in a competitive marketplace. A challenge to reasonable compensation usually occurs when one person is playing both the roles of payer and recipient, as with payments to a controlling shareholder of a C corporation.

When the IRS disallows an excess compensation deduction to a C corporation, and the employee is a shareholder, the excess compensation is usually treated as a dividend. Under current law, qualified dividends are taxed at the same rates as capital gains, so the consequences of a payment that is recharacterized as a dividend may not be too severe even with taxation of the income to both the corporation and the shareholder. However, the IRS also has the option of merely disallowing the deduction for excessive compensation, and leaving the income reported by the shareholder-employee unchanged.

Amount of Reasonable Compensation

The amount of reasonable compensation is inherently subjective, and there has been substantial litigation on this issue. An often cited case is *Mayson Manufacturing Co. v. Commissioner*, 178 F.2d 1157 (6th Cir. 1949), which lists several factors that may be used to assess the reasonableness of compensation. These factors include the following:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's work
3. The size of the business
4. The complexities of the business
5. A comparison of the salaries with the employer's gross and net income
6. The prevailing general condition of the economy
7. A comparison of the salaries paid with dividends paid to the shareholders

8. The salaries paid for similar positions in similar businesses
9. The salary policy of the corporation with respect to its employees, especially officers
10. Compensation paid to employees in previous years
11. Approval by the board of directors

Prior-year compensation may be important for a shareholder-employee who may have taken little or no salary during formative years when the business was not profitable. Approval by the board may not be very helpful in a one-shareholder corporation.

The IRS addressed the salary and dividend comparison issue in Rev. Rul. 79-8, 1979-1 C.B. 92, stating that while the failure of a closely held corporation to pay more than an insubstantial portion of its earnings as dividends is a very significant factor, deductions for reasonable compensation paid to shareholder-employees will not be denied on the sole ground that the corporation's dividend payments have been an insubstantial portion of its earnings.

In addition to the factors listed in *Mayson Manufacturing*, courts use an "independent investor" test as an overview. This test determines the level of return that would satisfy a hypothetical independent investor for the company in question. There are detailed calculations to value the business, determine the cost of capital, and calculate the return on such hypothetical valuation. If the return exceeds the cost of capital, the analysis indicates that the shareholder-employee is a competent executive and is probably worth the payment. If the income is less than the cost of capital, or does not meet the hypothetical expectations of the hypothetical investor, it appears that the owner is exploiting the company for excessive compensation. Obviously, this analysis requires an expert witness to value the business and to evaluate an appropriate level of compensation.

Some cases that discuss the independent investor test include the following:

- *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1243 (9th Cir. 1983)
- *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323 (5th Cir. 1987)
- *Dexsil Corp. v. Commissioner*, 147 F.3d 96, 100-101 (2d Cir. 1998)
- *Brewer Quality Homes, Inc. v. Commissioner*, T.C. Memo. 2003-200

The *Mayson Manufacturing* factors and the independent investor tests are theoretical concepts. However, the question faced in each of the cases is factual in nature. Thus, the tests are useful concepts in structuring an argument and provide a framework for presenting the evidence. Because each case is unique, it is difficult to generalize or to develop any universally useful formula for determining the compensation of an executive in a closely held business. Taxpayers who have achieved success have generally relied on some or all of the following factors:

1. A written compensation policy approved by the board of directors that documents the rationale for the compensation
2. Compensation that does not fluctuate with earnings
3. A bonus system that is not tied to net earnings but some other measure of the business performance, such as sales or cost control
4. A consistent, even if nominal, dividend history to develop a historical return on equity
5. Compensation of shareholder-employees that is not in the same ratio as stock ownership
6. Special training and experience
7. High compensation paid by other employers or to nonowners for similar services
8. Evidence that the shareholder-employee left a lucrative position to take his or her present one

Practitioner Note Compensation Facts and Circumstances

The IRS treats each excessive compensation case as unique. No one factor cited above solely determines reasonableness. The IRS and the courts consider the weight of the evidence using the factors that are present in a given situation. At a minimum, the company should maintain consistent and timely reporting of its payments to members. A recharacterization of a payment as compensation shortly after the IRS notifies the company that it is to be examined is less persuasive than employment contracts that predate the transactions. Consistent indicia of true employer-employee relationships are critical, especially when they are absent. A challenge also is more likely when a business is capital-intensive and when compensation is adjusted annually to match each year's profits and zero out the company's taxable income.

Catch-Up Payments

Taxpayers have been successful in defending high-compensation payments in some years where they were able to show that they were underpaid in earlier years. This has worked even where the compensation was contingent on corporate profits [see *H&A International Jewelry Ltd. v. Commissioner*, T.C. Memo. 1997-467].

This defense is particularly strong if the under- and overpayments were made pursuant to a written contract entered into prior to performance of services. Documentation that a shareholder-employee is underpaid when the corporation earnings are low (such as when the corporation is in its formative years or the industry is in a recession) is a must if this strategy is to work.

Repayment Agreements

A technique that once found favor with some practitioners was an agreement between the corporation and its employees that the employee must return any compensation found to be excessive. This provision is known as an "Oswald clause" from a well-known Tax Court case [*Oswald v. Commissioner*, 49 T.C. 645 (1968)]. In *Oswald* the corporation's bylaws required employees to repay excessive compensation. The court allowed the employee a deduction upon repayment.

The usefulness of this technique must be questioned, due to the following factors:

- The presence of such an agreement suggests that the corporation anticipates paying unreasonable compensation and may be self-defeating. The IRS has used these agreements as evidence that the corporation had preexisting knowledge that compensation paid was not reasonable.
- Currently, the usefulness of this technique may be severely limited due to the 2%-of-AGI floor on miscellaneous itemized deductions and the 3% cutback for high-income taxpayers.

If an employee repays excess compensation, but the repayment is not required by express employment agreement or the corporate bylaws, the employee may not be allowed a deduction for the repayment [*Pahl v. Commissioner*, 67 T.C. 286 (1967)]. Accordingly, it is important to preempt challenges to the employee's deduction by including an Oswald clause in employment agreements or bylaws.

Excessive Compensation of Nonowners

Sometimes a tax avoidance strategy involves shifting income to another family member. Payments to young children are especially susceptible to excessive compensation issues. Excessive compensation to family members of shareholders was disallowed in *Westbrook v. Commissioner*, T.C. Memo. 1993-634, and in *Carlins v. Commissioner*, T.C. Memo. 1988-79.

Insufficient Compensation of Business Owners

In each of the cases discussed in the previous sections, the IRS has attempted to decrease the amount of compensation claimed by the taxpayer. The principal weapon employed by the IRS has been I.R.C. § 162(a), which limits the deduction to a reasonable amount for services actually performed. However, the IRS may also assert that the compensation claimed by a taxpayer has been insufficient. This stance combats two areas of abuse:

- One taxpayer is attempting to assign earned income to another person.
- An S corporation shareholder is attempting to avoid FICA tax by disguising compensation as a corporate distribution.

There have been judicial assaults on the attempts by taxpayers to assign earned income to another person or entity. However, the IRS has been successful in attributing earned income to the person whose services gave rise to the earnings. An early Supreme Court case held that the person who earned income must report it, even if there was a valid contractual arrangement assigning that income to another person [*Lucas v. Earl*, 281 U.S. 111 (1930)].

Family Partnerships and S Corporations

I.R.C. §§ 1366(e) and 704(e) seek to prevent the use of S corporations and partnerships to circumvent assignment of income. The potential area of abuse is that a family member will give interests in an S corporation or partnership to children or other low-tax-bracket individuals and take minimal or no compensation for conducting the business, thus shifting profits to others.

I.R.C. § 1366(e) provides that a family member who provides services or capital to an S corporation should receive reasonable compensation or the income of the corporation may be reallocated among the family members. Similarly, I.R.C. § 704(e) addresses the problem of a partnership when one family member has given or sold equity interests to other family members.

The IRS has been successful in reallocating income to one family member when the services performed by that person were substantial and undercompensated [*Fundenburger v. Commissioner*, T.C. Memo. 1980-113].

However, the mere fact that there is a family S corporation does not give the IRS power to reallocate income to a family member who has performed only minimal services [*Davis v. Commissioner*, 64 T.C. 1034 (1975)].

Regulations also provide that the IRS can reallocate when there is a family S corporation and services are performed by a person or entity also under control of the family [Treas. Reg. § 1.1366-3(a)]; however, there has been little litigation on this issue.

Example 12.30 Family S Corporation

Frankie Wayne owns all of the stock of Frankie PC, CPA, a professional corporation providing CPA services in Indiana. Frankie PC is a C corporation. Frankie formed another corporation, Service, Inc., an S corporation that prepares computerized bookkeeping and payroll products for clients. Service does not require that the shareholders be licensed to practice in any profession, so he gave substantially all of his shares in Service to his children, Johnnie and Nellie.

Frankie does not work directly for Service. However, Frankie PC provides most of the management services for Service, including solicitation of clients, billing, and other client relation matters. Under Treas. Reg. § 1.1366-3(a) the IRS has the right to allocate some of the income away from Service to Frankie PC if Frankie PC is undercompensated for the work it performs for Service.

Practitioner Note Government Initiatives

S corporation employment taxes should be on a tax professional's watch list for future activity. In addition to current law compliance on the IRS's radar, legislative changes could occur.

A 2005 Treasury Inspector General for Tax Administration (TIGTA) report decried employment tax inequities that result from not assessing self-employment tax on an S corporation's ordinary income that passes through to more-than-50% shareholders. It suggests that changes should be made either through Treasury regulations or legislation [TIGTA Audit Report 2005-30-080].

The Congressional Joint Committee on Taxation has also begun to look at possible legislative changes, selecting employment taxation of S corporation shareholders as an area that should be revised to improve tax collections [Report JCS-2-05].

Attempts to Disguise Compensation to S Corporation Shareholder

In a 1974 revenue ruling, the IRS addressed a situation in which an S corporation distributed profits but paid its shareholders no salaries. The IRS held that the distributions were disguised compensation and that the corporation was responsible for payroll taxes [Rev. Rul. 74-44, 1974-1 C.B. 287]. Litigation followed in several cases in which shareholders attempted to receive distributions in lieu of salary payments. The IRS has won every case involving undercompensation of S corporation shareholders, and the courts have not even compromised on the amount of taxes, interest, and penalties levied by the IRS. Significant cases in this area include the following:

- *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990), *aff'g Radtke v. United States*, 712 F.Supp. 143 (E.D. Wis. 1989)
- *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1991)
- *Esser v. United States*, 750 F.Supp. 421 (D. Ariz. 1990)

Radtke and Esser were lawyers, and Spicer was a licensed public accountant. Thus, persons in the professions related to tax practice are not immune from successful IRS challenges to their compensation arrangements.

The IRS's approach to determining reasonable compensation can be seen in a 2001 Tax Court small tax case. The sole shareholder and only CPA who was employed by an S corporation CPA firm received a $2,000 salary in one year and none in the other years at issue. However, he also received more than $50,000 in distributions each year. To determine a reasonable level of compensation, the IRS used a placement firm survey. It then recharacterized most (but not all) of the amounts actually distributed as wages, based on the statistical data [*Wiley L. Barron, CPA, Ltd. v. Commissioner*, T.C. Summary Opinion 2001-10].

Summary of Compensation Issues

The battles between taxpayers and the IRS in the area of compensation take two directions. In excessive compensation cases the IRS is trying to limit a deduction claimed by a taxpayer. This usually occurs in the C corporation context. However, the opposite problem often occurs in the S corporation arena, where shareholders are trying to limit the FICA tax expense.

The C corporation cases tend to be complex and to involve expert witnesses trying to set a reasonable range of compensation. The S corporation cases have been much simpler, where shareholders have been performing services for S corporations and claiming no, or very little, compensation while taking distributions.

The excessive compensation case decisions have been mixed, with some deciding for the taxpayer and some for the IRS, and many in which the court compromises. On the other hand, the IRS has won every S corporation case where the corporation's compensation of the shareholder has been too low.

ISSUE 7: SELECTION OF BUSINESS ENTITY This issue explains the significant differences among the three principal business forms.

In 2015 the Joint Committee on Taxation published a study on the tax rules applying to partnerships, S corporations, and C corporations [Staff of the Joint Committee on Taxation, "Choice of Business Entity: Present Law and Data Relating To C Corporations, Partnerships, and S Corporations," April 10, 2015 (JCX-71-15)]. **Figure 12.8** replicates Table 1 from that document. The authors of the *National Income Tax Workbook* have expanded the table by adding a column for the sole proprietorship. All other additions are italicized.

FIGURE 12.8 Table of Comparison of Business Entities

Table 1. Principal Differences in Taxation of Partnerships, S Corporations, and C Corporations and Their Owners

Item	Partnerships	S Corporations	C Corporations	Proprietorships*
Limited liability company status for domestic entity	*Default status for multiple-member limited liability company.*	*Elective status for multiple-member limited liability company or single-member limited liability company if also qualified for S corporation status and filing Form 2553.*	*Elective status for multiple-member limited liability company or single-member limited liability company if also filing Form 8832.*	*Default status for single-member limited liability company.*
Maximum number of equity interests	No maximum number. Partnerships with over 100 partners may elect a special pass-through regime. (See I.R.C. §§ 771-777 and 6240-6255 for treatment of electing large partnerships.)	Maximum number of shareholders is 100. Family members treated as one shareholder for this purpose.	No maximum number.	One.
Classes of equity interests	No limitation.	One class of stock but can have voting and nonvoting stock.	No limitation.	Not applicable.
Ineligible entities	Generally, partnerships with equity interests that are publicly traded.	Foreign corporations; financial institutions using reserve method of accounting; insurance companies; DISCs and former DISCs.	None.	Not applicable.
Eligible shareholders	All persons eligible to be partners.	Eligible shareholders include individuals, estates and certain trusts, charities, and qualified retirement plans. *Must be US citizen, US resident, or US entity.*	All persons eligible.	Individual.
Foreign taxpayers	Eligible to be a partner; certain income subject to withholding tax.	Ineligible to be a shareholder.	Eligible to be a shareholder; dividends subject to withholding tax with possible reduced treaty rate; generally no tax on sale of stock unless effectively connected income.	Eligible.
Tax-exempt taxpayers	Eligible to be a partner; income subject to generally applicable unrelated business income tax.	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder. All items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income.	Eligible to be a shareholder; dividend generally not subject to unrelated business income tax.	Eligible to be a proprietor; income subject to generally applicable unrelated business income tax.
Trusts	Eligible to be a partner; usual trust taxation rules apply.	Only qualified subchapter S trusts and electing small business trusts eligible as shareholders; special taxation rules apply.	Eligible to be a shareholder; usual trust taxation rules apply.	Eligible.

Table 1. Principal Differences in Taxation of Partnerships, S Corporations, and C Corporations and Their Owners (Continued)

Item	Partnerships	S Corporations	C Corporations	Proprietorships*
Allocation of income and losses	Allocation in accordance with partnership agreement so long as allocation has substantial economic effect.	Pro rata among shares on a daily basis.	Not applicable (income and losses do not pass through).	All to proprietor.
Limitation on losses	Losses limited to basis in partnership interest, which includes partner's share of partnership debt. *Subject to amount at risk and passive activity loss limits*.	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis. *Subject to amount at risk and passive activity loss limits*.	Losses deductible against corporate income; NOLs generally can be carried back two years and forward 20 years; capital losses generally can be carried back three years and forward five years.	Subject to amount at risk and passive activity loss limits.
Contributions of property to entity	Tax-free; built-in gain or loss allocated to contributing partner.	Tax-free (if control requirement met); no special rules allocating built-in gain or loss to contributor.	Tax-free if transferors are in control of the company after the exchange; possible exception where contributed property is subject to debt.	Not applicable.
Distributions of property (liquidating or otherwise)	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner.	Any gain in distributed property is taxable (shareholders include it); FMV basis to shareholder; no basis adjustments to corporate property.	Any gain in distributed property taxable to the corporation; shareholder taxed if amount of distribution exceeds stock basis.	All business property treated as property of proprietor.
Transfer of equity interests	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price.	No ordinary income look-through provision; no adjustments to basis of corporate property.	Gain treated as capital.	Fully taxable, unless contributed to partnership or controlled corporation.
Termination of entity	Termination if sale or exchange of 50 percent or more of partnership interests within 12 months.	No provision.	Generally taxable to both corporation and shareholders.	Generally nontaxable.
Treatment of C corporation converting to partnership or S corporation.	Corporation must liquidate and gain or loss is recognized to corporation and shareholders.	Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 10 year period after election effective (special rules before 2015 shortened the period); distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income.	Not applicable.	Not applicable.

Table 1. Principal Differences in Taxation of Partnerships, S Corporations, and C Corporations and Their Owners (continued)

Item	Partnerships	S Corporations	C Corporations	Proprietorships*
Mergers and other reorganizations with corporations	Not eligible to engage in tax-free reorganization with corporation.	Eligible party to a tax-free corporate reorganization.	Generally tax-free.	
Corporate tax rules of subchapter C	Rules inapplicable.	Rules generally applicable.	Rules applicable.	Rules inapplicable.
Wholly owned corporation	Corporation treated as separate entity.	Wholly owned subsidiary corporation may elect to be treated as part of parent S corporation.	Not subject to tax on dividends or liquidating distributions paid between wholly-owned subsidiaries.	Corporation treated as separate entity.
Application of employment and self-employment (OASDI and HI) taxes	Except in certain cases involving a limited partner not performing services, each partner's share of net business income is net earnings from self-employment.	Amounts paid as compensation to a shareholder-employee are wages subject to FICA; no amount of shareholder's share of S corporation income is net earnings from self-employment; case law provides "reasonable compensation" is wages subject to FICA.	Amounts paid as compensation are wages subject to FICA; no amounts are net earnings from self-employment.	Net business income is net earnings from self-employment.
Treatment of earnings as investment income for purposes of the net investment income (NII) tax	Business income of limited partners who are not active in the business which is not net earnings from self-employment is treated as investment income for the NII tax.	Business income of S corporation shareholders not active in the business is treated as investment income for the NII tax.	Dividends paid to individuals by C corporations are treated as investment income for the NII tax.	Taxable as NII unless subject to self-employment tax.

* Added by authors of the *National Income Tax Workbook*.