

Structure Counts! The Tax Implications Arising From the Formation, Operation and Liquidation of C Corporations, S Corporations, Partnerships and Limited Liability Companies

By Agnes Gesiko

Agnes Gesiko analyzes tax and nontax implications arising from the use of various business entities. She describes several advantages and disadvantages of utilizing particular entity structures.

Tax and nontax considerations often govern the type of entity structure utilized for a particular business venture. The right form of entity that is ultimately preferred is one that will offer investors maximum liability protections coupled with greatest investment returns. Factors that play a vital role in accomplishing this goal consist of (i) profit maximization through use of effective tax rates, (ii) full utilization of losses generated by the respective entity, (iii) investor liability limitation from the debts and obligations of the entity, (iv) ability of the entity to raise finance and access capital markets, and (v) ease of investment liquidity and entity exit strategy. These factors often come into play throughout the various stages of an entity's existence—from its organization throughout its operation and during its liquidation. This Article will discuss various Internal Revenue Code (the "Code") provisions that govern the forma-

tion, operation and liquidation of C corporations, S corporations, partnerships and limited liability companies. Furthermore, this Article will set forth various tax considerations that should be considered before a particular entity structure is adopted for a specific business venture.¹

C Corporations

Formation

A corporation is a business entity organized under a federal or state statute, if the statute refers to the entity as incorporated or as a corporation, body, corporate or public body.² Typically, the incorporation of a C corporation will depend on the advantages and disadvantages offered by a particular state's law (e.g., Delaware) and the costs associated with incorporating the entity in a particular state.

One of the greatest advantages of utilizing a C corporation is the limited liability that such a structure offers to investors. Specifically, liability is limited to the amount that an individual invests in the entity (*i.e.*, as typically reflected in stock ownership). Furthermore, there are no restrictions on (i) the types

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of owners (*i.e.*, individuals, S corporations, partnerships, *etc.*) that may invest in the entity, or (ii) the maximum number of owners. The capital structure of a C corporation is flexible and may consist of the issuance of different classes of stock (*i.e.*, common and/or preferred) with different rights and preferences for particular investors. As such, this allows the C corporation flexibility to raise money in a variety of ways. Furthermore, the C corporation structure permits utilization of employee compensation alternatives, including stock options and deferred compensation arrangements. For example, incentive stock options³ may be utilized as a mechanism for retaining qualified employees and a means of improving employee performance.⁴ The expenses incurred in the organization of a C

corporation, such as attorneys' fees for advice pertaining to a corporation's capital structure, accountant fees, state filing charges, *etc.*, all of which serve to benefit future periods of the entity, can be capitalized.⁵ Typically, this capitalization is allowed ratably over a period not less than 60 months.

Another advantage of utilizing a C corporation as the entity of choice is the formalized and tested legal relationship that this structure offers among directors, shareholders and officers. This formal structure may be desirable especially when there are a large number of investors, most of which desire a passive role in the entity.⁶ However, it is also important to point out that there may be high annual costs associated with the observance of corporate formalities, such as director meetings and annual and special shareholder meetings.⁷ Failure to properly comply with these requirements may lead to "*piercing the corporate veil*" claims and expose shareholders to liability that exceeds the amount they have invested in the entity.

A C corporation is generally allowed to choose either a calendar year or a fiscal year for its reporting period.⁸ However, a corporation that constitutes a personal service corporation⁹ must adopt a calendar year for tax purposes unless it can satisfy the Internal Revenue Service's (IRS's) requirements that

there be a business purpose for a fiscal year.¹⁰ Most C corporations will not be allowed to use the cash method of accounting.¹¹

The initial infusion of capital into a C corporation by shareholders in exchange for stock is tax-free provided that certain requirements are satisfied. Specifically, (i) the transfer must consist of property (*e.g.*, money, real property such as land and buildings, and personal property such as inventory and equipment)¹² to the corporation, (ii) transferors of property qualify only if they control the corporation after the exchange (*i.e.*, transferors own (i) at least 80 percent of the total combined voting power of all classes of stock entitled to vote and (ii) 80 percent of the total number of shares of each class of nonvoting stock of the corporation immediately after the exchange),¹³

and (iii) nonrecognition will apply only to the extent that solely stock is received in the transaction.¹⁴ These requirements apply to capital infusions made into a C corporation initially during formation and subsequently during operation. For example, after a C corporation has been formed and operated for a time, an infusion of capital to the business might be necessary requiring either a new or an old shareholder, or both, to make a transfer to the corporation. It might be difficult for such additional infusions of capital to be tax-free since the Code requires the transferors to be in control of the entity after the transfer of property.¹⁵

Operation

The operations of a C corporation may be funded through a number of different mediums that encompass direct cash or property contributions by shareholders, the issuance of stock or the acquisition of debt by the entity. Cash contributions by a shareholder to a C corporation any time during its operation results in an increase in the basis of the stock held by the shareholder.¹⁶ Where a shareholder contributes property to a C corporation, it will result in an increase in the shareholder's basis equal to the basis of the property transferred plus any gain recognized.¹⁷ If stock is received in exchange for

One of the greatest advantages of electing S corporate status is the ability of shareholders to currently utilize any losses that are generated by the entity. Specifically, shareholders are allowed to deduct their share of losses to the extent of their basis in the entity's stock and the basis attributable to any debt of the corporation.

such cash or property contributions then in order for such an exchange to be tax-free, the transferors must be in control of the corporation as required under Code Sec. 351, as discussed above. Otherwise the exchange will be treated as a taxable disposition and the taxpayer will be required to recognize gain or loss to the extent that the value of the property received exceeds or is less than the adjusted basis of the property transferred.¹⁸ Furthermore, any dividends declared and paid on the stock owned by a shareholder is subject to double taxation—once at the corporate level and then again at the shareholder level. Such double taxation extends to distribution of appreciated property that is subject to a corporate level tax and then taxed to the recipient shareholder as an ordinary income dividend, unless such distribution satisfies the liquidation or spin-off rules.¹⁹

The utilization of debt might also prove to be a valuable alternative in a C corporation's operations. One of the advantages of utilizing debt is that interest payments can be deducted by the C corporation against taxable income, whereas dividend payments cannot.²⁰ Thus, the corporation's cost of using debt to raise capital may be less than the cost for the stock. Furthermore, utilizing debt as a mechanism to foster operations enables the C corporation to avoid double taxation. However, the use of such debt may result in certain limitations on deductibility of interest not applicable to the other types of entities (e.g., partnerships). Specifically, interest on debt to related persons, certain debt instruments and incurred indebtedness by a corporation to acquire the stock/assets of another corporation may be disallowed.²¹ Furthermore, shareholders will not receive any benefits from the acquisition of such debt, such as an increase in their stocks basis, as they may in the utilization of some of the other entity structures. Repayments of debt are generally treated as a tax-free return of the debt's principal. In sum, when an investor in a publicly held C corporation needs funds, the investor may sell his investment (e.g., stock or debt) and obtain a tax-free recovery of the investment's cost and a capital gain tax on the excess.²² If stock or debt becomes worthless a capital loss is usually recognized. Deductions for worthlessness are normally restricted to the extent of capital gain plus \$3,000.²³

Furthermore, any earnings and losses generated by a C corporation remain at the entity level and their utilization is impacted by certain Code provisions. Specifically, the Code levies a tax on any accumulated earnings that accumulate at the entity level

instead of being divided or distributed.²⁴ Accumulated earnings are typically amounts that the corporation could have distributed after funding its reasonable needs.²⁵ The accumulated earnings tax will not be raised as an issue unless the corporation's balance sheet shows cash, marketable securities or other liquid assets that could be distributed to shareholders. Typically, the absence of liquid assets indicates that any earnings that have been retained have been reinvested in the business rather than accumulated for a forbidden purpose.²⁶

In addition to the taxes that may be applicable to a corporation's earnings, there may also be certain limitations on a corporation's ability to use its losses. Specifically, a C corporation's losses accumulate at the corporate level in the form of net operating loss (NOL) carryback and carryforward deductions and can be utilized only against a corporation's taxable income.²⁷ NOLs not utilized in the requisite time period expire.²⁸ Furthermore, utilization of a C corporation's NOLs may be limited in situations where the corporation is part of a affiliated group²⁹ or files a consolidated return.³⁰

Liquidation

One of the advantages of utilization and issuance of stock for purposes of raising capital is that it is freely transferable on the open market.³¹ Specifically, shareholders can liquidate their interest in a C corporation rather quickly *via* the sale of their stock.³² Furthermore, foreign investors in C corporations are not subject to taxation in the United States on the sale of their corporate stock unless the foreign investor has a separate U.S. trade or business with which the sale is effectively connected or a U.S. permanent establishment to which the sale is attributable under an applicable treaty.³³ Lastly, a C corporation's stock may also be used as a tool in situations where reorganization is sought by the entity, and as such, if properly structured, shareholders may receive tax free treatment under the Code.³⁴

S Corporations

Formation

A corporation that constitutes a small business corporation will be taxed according to the rules of subchapter S only if the corporation elects to be subject to subchapter S tax provisions.³⁵ A qualifying election exempts the entity from the C corporate income tax and all other federal income taxes normally

imposed on C corporations.³⁶ This means that for federal tax purposes, no tax is imposed on the entity-level of an S corporation.³⁷ Rather, items of income, gains, losses and tax credits flow through to shareholders who must report and are taxed on these items accordingly.³⁸ The S corporation is simply required to file an informational return (*i.e.* Form 1120S). Even though it is a conduit entity for tax purposes, the S corporation is treated as a legal entity separate from its owners. Like a C corporation, its management structure and operations are subject to relatively rigid corporate formalities that often lead to higher costs of operations. Failure to properly comply with these requirements may lead to “*piercing the corporate veil*” claims and expose shareholders to liability that exceeds the amount they have invested in the entity.

An S corporation may have as its tax year (i) a calendar year,³⁹ (ii) a fiscal year if it is a natural business year,⁴⁰ (iii) a fiscal year if its majority shareholders are on the same year,⁴¹ and (iv) a fiscal year under the special election of Code Sec. 444.⁴²

In order to make a qualifying S corporation election, certain requirements must first be satisfied. Specifically, S corporate status is given only to entities that are (i) domestic corporations, (ii) have no more than 100 shareholders, and (iii) have only one class of stock.⁴³

Hence, foreign corporations will not qualify for S corporation status. Certain types of domestic corporations are also ineligible from S corporate status. Specifically, insurance companies, banks using the reserve method of accounting for bad debts, corporations electing the special possessions tax credit under Code Sec. 936 and domestic international sales corporations are all ineligible from making an S corporate status election.⁴⁴

Furthermore, S corporations can have no more than 100 shareholders. Additionally, the stock of an S corporation may be owned only by (i) individuals who are citizens or resident aliens of the United States,⁴⁵ (ii) estates, (iii) certain trusts,⁴⁶ and (iv) charitable organizations, pension trusts and employee stock ownership plans.⁴⁷ Nonresident aliens (*i.e.*, generally foreign citizens resident outside the United States), C corporations, partnerships and certain trusts are not allowed to hold stock in an S corporation. Thus, acquisition of an S corporation’s stock by one of these parties terminates the election. Furthermore, it is important to keep in mind that these restrictions on stock ownership may ultimately serve to limit potential equity financing sources.

Lastly, in order to effectuate a valid S corporation election, the entity may have only one class of stock outstanding.⁴⁸ Shares satisfy the one class of stock requirement if they confer identical rights to distribution and liquidation proceeds (*i.e.*, corporate income, gain, deduction, loss or credit).⁴⁹ Both voting and nonvoting common stock are permissible for an S corporation, as differences in voting rights are disregarded in determining whether a corporation has more than one class of stock.⁵⁰ However, options, warrants and convertible debt are treated as a second class of stock if certain requirements are met.⁵¹ With only one class of shares permitted, profits and losses must be allocated among the shareholders on a *pro rata* basis.⁵²

Nonequity instruments or obligations do not count as a second class of stock as long as the general equity/debt classification principles in the Code do not lead to a re-characterization of the instrument or obligation as equity.⁵³ Typically, straight debt will not be classified as a second class of stock if (i) the interest rate and the interest payment dates are not contingent on either the corporation’s profits, management’s discretion or similar factors, (ii) the instrument cannot be converted into stock, and (iii) the creditor is an individual estate, trust, charitable organization or pension trust that is eligible to hold stock in an S corporation of any person that is actively and regularly engaged in the business of lending money (*e.g.*, a financial institution such as a bank).⁵⁴ It is important to point out that all of these requirements must be satisfied not only at the time an election is made to be treated as an S corporation but all times thereafter as well.⁵⁵ An S corporation that has lost its S corporation status cannot qualify as an S corporation for another five years.⁵⁶

Contributions of property into an S corporation in exchange for stock will be nontaxable only if the persons involved in the transaction own at least 80 percent of the S corporation after the transfer is completed.⁵⁷ Like C corporations, this generally means that a new S corporation can be formed with nontaxable exchanges of assets for stock. However, this restriction often results in taxable transfers of subsequent similar exchanges when the S corporation has been in existence for some time.

Operation

Since an S corporation is a separate legal entity from its owners, elections for income calculation purposes will be made at the S corporation level.⁵⁸

Such elections include decisions such as the entity's method of accounting, depreciation calculations, *etc.* Shareholders who decide to perform services for the S corporation will be viewed as employees.⁵⁹ As such, salaries paid to these individuals, as well as payroll taxes attributable to such salaries, will be deductible by the S corporation.⁶⁰

All S corporation items (*i.e.*, profits, losses, *etc.*) are allocated and flow through to shareholders based on their then ownership interest in the entity's outstanding stock.⁶¹ Most distributions⁶² by an S corporation are considered nontaxable to the extent of the shareholder's stock basis.⁶³ Any distribution in excess of the shareholder's stock basis is treated as gain from the sale of the underlying stock,⁶⁴ and as such, subject to capital gain taxation.⁶⁵

One of the greatest advantages of electing S corporate status is the ability of shareholders to currently utilize any losses that are generated by the entity. Specifically, shareholders are allowed to deduct their share of losses to the extent of their basis in the entity's stock and the basis attributable to any debt of the corporation.⁶⁶ Losses exceeding a shareholder's basis may be carried forward indefinitely and be utilized when there is an increase in the shareholder's basis.⁶⁷ If there are many loss items and insufficient shareholder basis, then each loss item is allocated *pro rata* against the shareholder's basis.⁶⁸

Shareholders may make subsequent property contributions into an S corporation in exchange for additional stock. In order for such contributions to receive tax-free treatment, the 80-percent control requirement must be satisfied. Thus, transfers by new investors into an S corporation will be a taxable exchange unless the transferor owns 80 percent of the S corporation's stock subsequent to the transfer. This requirement makes it much more difficult for an S corporation to admit a new investor. While this result may be avoided if existing owners are willing to accommodate the new

investor with their own simultaneous contributions of property, this may not be possible.

Utilization of a tiered S corporation may be an attractive possibility for a proposed business venture. An S corporation may own 100 percent of the stock of subsidiaries by making a qualified subchapter S subsidiary (QSSS) election.⁶⁹ A QSSS is a corporation that exists as a separate entity for nontax purposes but is treated as a disregarded entity for tax purposes.

As such, the parent S corporation reports all of the income and deductions of the QSSS along with its own tax items.⁷⁰

It is also important to point out that C corporations who later elect to become S corporations may be subject to additional taxes on the earnings and profits that they accumulate while operating as a C corporation and on passive investment income.⁷¹ Specifically, an S corporation will be required to pay a special tax on its passive income if it has both accumulated earnings and profits at the

end of its tax year and its passive investment income exceeds 25 percent of its gross receipts for that year.⁷² Additionally, when a corporation has accumulated earnings and profits and excessive passive income in three consecutive years, the corporation's S corporate status is terminated.⁷³ Similarly, any gain that is generated and recognized from the sale of an asset during a 10-year period following the S election by a C corporation is subject to the built-in gains tax.⁷⁴

Liquidation

S corporation shareholders can liquidate their interest in the entity quickly *via* the sale of their stock. The amount of gain or loss that will result is dependent on the shareholder's basis in the S corporation. Additionally, utilization of shares as a method for facilitating operations may enable the S corporation to take advantage of the tax-free reorganization provisions of Code Sec. 368 as an exit strategy.⁷⁵ Furthermore, the S corporation is positioned well to take advantage of a variety of other liquidation alternatives, such as

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initial public offerings and asset or stock sales with an election pursuant to Code Sec. 338(h)(10).⁷⁶

Partnerships⁷⁷

Formation

A partnership is defined as an “association of two or more persons to carry on as co-owners a business for profit.”⁷⁸ This definition includes a syndicate, group, pool, joint venture or any other unincorporated organization.⁷⁹

A partnership operates as a conduit for federal income tax purposes. This means that the partnership itself is never subject to federal income tax, and that all items of partnership income, expense, gain or loss pass through to the partners and are given their tax effect at the partner level.⁸⁰ The partnership is simply required to file an informational return (*i.e.*, Form 1065) describing the results of the partnership’s business transactions and the manner in which items are allocated among the partners. Each share of the partner’s distributive share is reported on a Schedule K-1.⁸¹ The partnership is allowed to utilize a variety of accounting methods (*e.g.*, cash receipts and disbursements method, the accrual method or a hybrid accounting method) in the calculation and allocation of partnership items to respective partners.⁸² The amount of each pass through item that is allocated to individual partners is deemed to occur on the last day of the partnership’s tax year.⁸³

A partnership’s tax year is either (i) the tax year used by one or more partners who own more than a 50-percent aggregate interest in the partnership’s capital and profits, or (ii) if no such majority interest tax year exists, then the tax year is one that is used by its principal partners (*i.e.*, those partners owning at least a five-percent interest in partnership capital or profits).⁸⁴ It is important to point out that these rules can be avoided and a different tax year adopted (without reference to the tax years of the partners) provided that the partnership is able

to convince the IRS that there is a valid business purpose for such year.⁸⁵ Generally a partnership has a business purpose for adopting a tax year that conforms to its natural business year.⁸⁶ Partnerships are free to elect among several methods of accounting. These include the cash receipts and disbursement method, the accrual method or a hybrid method of accounting.⁸⁷

As an entity form, the partnership is one of the more flexible entities from both an organizational and operational standpoint. Partnerships are allowed to make allocations and distributions of partnership items, discussed above, as determined and decided by

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the partners. Additionally, a partnership’s management structure is much more flexible than that of a corporation. As such, there are no formalities that must be satisfied on an annual basis in order to operate the partnership. Also, a partnership may have an unlimited number of partners and there are no limitations on who or which type of entity may be a participant.⁸⁸

Despite the organizational and operational flexibility of this entity, liability exposure for the

debts and obligations of the entity may be significant for each of the partners. A general partnership will expose all partners to unlimited joint and several liability. So, for example, a contract entered into on behalf of the general partnership will bind everyone, even if the other partners do not consent to the contract’s terms and conditions. In limited partnerships,⁸⁹ general partners will encounter unlimited liability exposure, whereas limited partners will be liable for debts and obligations of the entity only to the extent of their capital contributions to the partnership.⁹⁰ This is why a partnership as an entity form is utilized often for simple joint venture arrangements, where third-party exposure is not a meaningful concern. However, it is important to point out that liability exposure may be curtailed through the purchase of appropriate insurance.⁹¹

Start up cost for partnerships are generally minor since most states do not require registration and

the filing of fees. Any costs incurred to organize a partnership, such as legal fees for drafting the partnership agreement and filing fees charged by the state in which the partnership is formed, must be capitalized and are not deductible as ordinary and necessary business expenses. The partnership may elect to amortize these organizational costs over 60 months beginning with the month in which the partnership begins business.⁹² Any syndication fees connected with the issuance and marketing of partnership interest must also be capitalized. These fees may not be amortized and will remain as an intangible asset on the partnership books until the partnership is liquidated.⁹³

Operation

Each partner's distributive share of any item of partnership income, gain, loss, deduction or credit is determined by reference to the partnership agreement.⁹⁴ Partnerships are allowed to allocate profits and losses to each partner on an equal basis or a different allocation regime where different items of gain or loss are shared in different rations among different categories of partners. However, in order for such allocations to be respected by the IRS, certain Code requirements (e.g., capital account maintenance, substantial economic effect,⁹⁵ etc.) must be satisfied.⁹⁶ Participants oftentimes do not understand the complexities surrounding these requirements. Additionally, the nonfungibility resulting from the ownership of partnership equity interests may result in significant obstacles for certain types of investors (e.g., foreign investors).

Generally, a partner is not taxed on a contribution of property to the partnership in exchange for a partnership interest.⁹⁷ This nonrecognition rule does not apply when an incoming partner contributes personal services to a partnership in exchange for a capital interest that is not subject to any restrictions.⁹⁸ Here, the receiving partner must recognize ordinary compensation income to the extent of the value of such capital interest.⁹⁹ The amount of income recognized becomes the partner's initial outside basis in the interest received.¹⁰⁰ The treatment is unclear, however, for a partner receiving an interest in a partnership's future profits.¹⁰¹

Payments made to partners without regard to the partnership's income in exchange for services performed by the partners (i.e., so-called "guaranteed payments")¹⁰² constitute ordinary income for the recipient partner.¹⁰³ The partnership may either de-

duct the guaranteed payment as a business expense or capitalize it accordingly.¹⁰⁴ Cash basis partners will include guaranteed payments in their income in the year that includes the last day of the partnership year during which the guaranteed payments were accounted for at the partnership level.¹⁰⁵

One of the greatest advantages in utilizing a partnership structure is that operating losses that are generated by a partnership yield an immediate tax benefit to the extent the partner has sufficient basis. Here it is important to point out that a partner's basis includes their share of partnership liabilities.¹⁰⁶ It also includes any partnership debt that is assumed by the partner.¹⁰⁷ Even if the partner has sufficient basis in the partnership interest to fully realize the loss, both the at-risk rules and the passive activity loss rules must be satisfied in order for the partner to recognize the loss.¹⁰⁸ The at-risk rules provide that losses may be deducted from a partnership activity only to the extent of a partner's at-risk amount in such an activity.¹⁰⁹ The passive activity loss rules provide that when a partnership interest represents a passive activity, the partner's distributive share of partnership losses can be deducted only against current income from other passive activities; the losses cannot be deducted against the partner's earned income, income from nonpassive business activities or portfolio income (i.e., investment income such as interest and dividends).¹¹⁰

As a general rule, distributions of cash or property are tax-free up to the taxpayer's basis in the partnership. Thus, a cash distribution simply reduces the partner's basis by the amount of money received.¹¹¹ In situations where a distribution of property is made, the partner's basis is allocated among the property received and his/her continuing interest in the partnership.¹¹² However, it should be pointed out if the distribution is disproportionate, then tax may apply.¹¹³

Partnerships may find it difficult to attract and raise capital from foreign investors. This is because the activities of a partnership are generally imputed to foreign investors. Hence, a trade or business and office or permanent establishment in the United States is attributed to its foreign partner. This subjects the foreign partner to the necessity of filing U.S. income tax returns and paying tax at U.S. marginal tax rates.¹¹⁴ Furthermore, distributions of income to foreign investors may be subject to withholding tax.¹¹⁵ The withholding rate may be reduced by an applicable treaty.

Liquidation

Partners may encounter several limitations on the transferability of their partnership interest. Usually partnership agreements impose specific contractual provisions that impede the partners' right to sell their partnership interests to third parties (e.g., right of first refusal, majority partner approval, etc.). Thus, the presence of such restrictions on the sale of partnership interests may dissuade certain individuals from participating in this form of entity structure. Also, any losses that result on the disposition of a partnership interest are usually capital in nature and cannot be offset against ordinary income.¹¹⁶

In addition to the limits of partnership transferability, it is important to point out that transfers of partnership interest may also lead to the termination of the partnership. Specifically a partnership shall terminate for tax purposes only if (i) no part of any business, financial operation or venture is being conducted by the partnership (i.e., natural termination) or (ii) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.¹¹⁷

A partnership may be incorporated tax-free, such as in connection with an initial public offering.¹¹⁸ However, limitations exist on exit strategies that involve the receipt of corporate stock because the partnership may not be a party to a tax-free reorganization. Rather, mergers of partnership will be respected only if the merger takes the "asset-over" form or the "asset-up" form. In an "asset-over" merger, the terminated partnership is treated as contributing its assets and liabilities to the resulting partnership in exchange for an interest in the partnership, and then the terminated partnership is treated as making a liquidating distribution to its partners of the interests in the resulting partnership.¹¹⁹ An "asset-up" merger occurs when the assets of the terminating partnership are distributed to the partners of such

partnership, who subsequently contribute the assets and liabilities to the resulting partnership.¹²⁰

Limited Liability Companies

A limited liability company (LLC) may be taxed as (i) a corporation (i.e., C corporation or S corporation), (ii) as a partnership, provided there is more than one participant, or (iii) a "disregarded entity" where there is only one participant.¹²¹ Thus, the ultimate tax consequences attributable to an LLC will depend on how the entity elects to be taxed for income tax purposes.¹²² For example, electing to be taxed as a disregarded entity may be preferred for income tax reasons when there is also the desire to take advantage of some of the other benefits, as discussed below, of using the LLC form.¹²³

One of the greatest advantages of an LLC is the limited liability this entity offers to its participants (also known as "members"). Liability of members is limited to their investment in the LLC. Members can consist of partnerships, S corporations, C corporations, individuals, etc. Furthermore, different classes of members can exist, each with their own rights and preferences in an LLC's profitability and assets.

An LLC is not subject to rigid formalities, as is the case for a C corporation.

For example, director and shareholder meetings are not required in order to preserve limited liability. Thus, there are no formal requirements to comply with certain formalities, as required for some of the other entity types. Rather, the LLC is an entity that offers investors maximum management and operational flexibility. Here, all or certain members may participate in management without the risk of being held liable for the debts of the LLC. Such members may also have an independent management role without a direct interest in the LLC.

However, certain states may impose special or higher taxes or fees on the use of an LLC structure.

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For example, California imposes a minimum franchise tax in addition to a gross receipts fee on LLCs formed and operating in the state. Fees of this type may make the utilization of this entity structure more expensive, especially in situations where an investor adopts a tiered LLC structure consisting of many LLCs for a particular business venture.

Conclusion

Tax considerations greatly impact the determination of what type of entity is ultimately utilized for

a particular business venture. Investors will want to choose an entity that will generate the best return on their investment through profit maximization, loss utilization and liability limitation. Furthermore, investors will seek to adopt entities that can raise finance and access capital markets easily in order to accomplish their particular business goals while at the same time afford them the ability to liquidate their investment in the entity quickly. Thus, obtaining tax advice will be key in achieving these goals during the formation, operation and ultimate liquidation of a particular business entity.

ENDNOTES

- ¹ Note that this Article seeks to address only some of the tax implications that arise from the utilization of a particular entity structure under the Code. It will not address implications that may arise from other type of law (*i.e.*, state law, corporate law, *etc.*), which too may have an impact on the type of entity ultimately chosen for a particular business venture. Rather, the purpose of this Article is to serve only as an overview of some of the tax implications that arise from using one entity versus another.
- ² Code Sec. 7701(a)(3). All references to the Code hereinafter refer to the Internal Revenue Code of 1986, as amended. Code Sec. 11 imposes a tax on all corporations. Such tax applies to both domestic and foreign corporations and corresponds to foreign and domestic source income. Code Sec. 882(a). Certain corporations, however (*i.e.*, corporations organized not for profit but for religious, charitable, scientific, literary, educational, or certain other purposes), are not subject to tax. Code Sec. 501(a). Structural advantages arising from the use of international corporations in multi-tier structures or as blocker entities will not be addressed in this Article. However, it is important to point out that corporations that are organized abroad and utilized in multi-tier structures may take advantage of certain favorable Code and/or international treaty provisions. This discussion, however, is beyond the scope of this Article.
- ³ For tax consequences of issuing and exercising incentive stock options, see Code Secs. 421, 422.
- ⁴ For additional data illustrating the impact that stock option programs have on employees, see John J. McConnel & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 J. FIN. ECON. 595, 603-09 (1990) (finding that as management's percentage of stock ownership increased from zero percent to approximately 40 percent so did corporate performance). For further analysis of how corporations use the tax system to influence managerial behavior, see James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis*, 67 *NORTE DAME L. REV.* 971, 1017 (1992).
- ⁵ Code Sec. 248. Organizational expenditures include items such as (i) legal services incident to the creation of the corporation, (ii) necessary accounting services, (iii) expenses of temporary directors and of organizational meetings of directors or stockholders, and (iv) fees paid to the state of incorporation. Code Sec. 248(b); Reg. §1.248-1(b)(2). Note that attorneys' fees and accountants' fees that do not serve to benefit the future periods of the C corporation may be deductible as ordinary and necessary business expenditures. Code Sec. 161.
- ⁶ So, unlike some of the other entities that are discussed in this Article, investors in C corporations do not actively participate in the management of this entity.
- ⁷ Such rigid formalities might not be desirable when there are only a few investors involved.
- ⁸ Code Sec. 441(b).
- ⁹ A personal service corporation is a corporation whose principal activity is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts or consulting, and substantially all of the stock is owned by employees, retired employees or their estate. Code Sec. 448(d)(2).
- ¹⁰ Code Secs. 441(i), 444.
- ¹¹ However, the cash method of accounting may be used by (i) corporations with average annual gross receipts of \$5,000,000 or less in all prior tax years, (ii) S corporations, and (iii) personal service corporations. Code Sec. 448.
- ¹² Note, however, that the term property does not include services. Code Sec. 351(d)(1).
- ¹³ Code Sec. 368(c); Rev. Rul. 59-259, 1959-2 CB 115. Here it is important to point out that the second part of the test is irrelevant when a corporation only issues voting stock—which may be the case if it is a newly formed corporation.
- ¹⁴ This ensures that nonrecognition is granted when the transferor has not used the exchange to effectively liquidate on the investment in the property transferred. If other property is received, however, then the taxpayer will have to recognize gain to the extent that other property (*i.e.*, "boot" in tax terminology) is received. Code Sec. 351(b).
- ¹⁵ Hence, in order for a subsequent transfer of capital by an investor into a C corporation to be tax-free, investors representing 80 percent of stock ownership must also participate in the capital infusion. Thus, it might be difficult to gather the respective amount of investors to facilitate a tax-free transfer.
- ¹⁶ Reg. §1.118-1.
- ¹⁷ *Id.*
- ¹⁸ Code Sec. 1001(a), (b) and (c).
- ¹⁹ Code Secs. 331, 355.
- ²⁰ However, it is important to point out that a corporation cannot be too thinly capitalized (*i.e.*, have a capital structure that consists primarily of debt rather than stock), since this may lead to recharacterizing all or a portion of its debt as stock. This can result in significant tax consequences such as all interest payments previously made being treated as dividends, and therefore, not deductible and as such, subject to double taxation.
- ²¹ Code Secs. 163(j), 163(l), 279. For example, a loss on the sale of property from a corporation to a shareholder who owns more than 50 percent of the corporation is nondeductible. Rather such loss must be suspended and may be used by the shareholder to offset gain with the property is sold.
- ²² Note that this may not be the result for an investor who is a shareholder in a closely held corporation where there is a smaller market for the investment and a transfer to an outsider would probably not be acceptable. It is also important to point out that Code Sec. 1202 (*i.e.*, gain exclusion) and Code Sec. 1045 (*i.e.*, tax-free rollover) offer certain tax benefits to noncorporate shareholders of qualified business stock if such stock represents ownership in a "qualifying small

business corporation" (i.e., one in which the total money and property that the corporation receives for stock as contributions to capital and paid in surplus does not exceed \$1,000,000). Code Sec. 1244(c)(3).

²³ See generally Code Sec. 1244, which is an exception to this general principle and provides that investors owning Code Sec. 1244 stock are entitled to ordinary loss treatment if the stock is disposed of at a loss or if it becomes worthless.

²⁴ Code Sec. 532. However this tax is not applicable to certain types of corporations. For example, domestic and foreign personal holding companies, tax exempt corporations, and passive foreign investment companies are not subject to this tax. Code Sec. 532(b). Here it is important to point out that this is only one type of tax that can be imposed on a corporation. For example, the personal holding company tax may also apply if the corporation is considered a personal holding company. Code Sec. 542. A corporation is deemed to be a personal holding company if (i) at any time during the last half of the tax year, more than 50 percent of the value of the corporation's stock is owned by five (5) or fewer individuals, and (ii) at least 60 percent of the corporation's adjusted ordinary gross income consists of personal holding company income. Code Sec. 542(a). This illustrates that the type of taxes that may be applicable to corporations are ultimately dependent on the classification and purpose of the corporation.

²⁵ Code Sec. 535. The accumulated earnings tax is imposed on accumulated taxable income which is in essence a formula based on a C corporation's taxable income and adjusted for certain items (i.e., federal income taxes for the year, charitable contributions in excess of the 10-percent limitation, etc.). For a complete list of the adjustments that are made to derive a corporation's accumulated taxable income, see Code Sec. 535(b).

²⁶ One way to avoid the repercussions of the accumulated earnings tax is to make an S corporation election as these entities are immune from the accumulated earnings tax. C corporations who make the election to avoid this tax may still be subject to the tax for all prior years that they operated as a C corporation. Additionally, it is important to point out that certain type of corporations may be subject to other types of taxes.

²⁷ Code Sec. 172(b).

²⁸ Code Sec. 172(b)(1)(A).

²⁹ An affiliated group refers to one or more chains of includible corporations connected through stock ownership with a common parent corporation. Code Sec. 1504(a). Here it is also important to point out that Code Sec. 382 may operate to disallow any NOL carryovers in full or limit them to a fraction of their total. Reg. §1.1502-21(d).

³⁰ Code Secs. 1501, 1502. Consolidated tax return aggregate items composing taxable income of certain related corporations (e.g., a parent corporation and its 80-percent owned subsidiary).

³¹ Note that this statement does not hold true for shareholders in a closely held corporation, as there is typically a limited market for the sale of their shares.

³² Note that losses on the sale of stock will be disallowed if a shareholder owns more than 50 percent of the stock. Code Sec. 267(b).

³³ Code Sec. 864(c)(3), (4) and (5); Treas. Reg. §§ 1.864-4, 1.882-1. However, dividends paid to foreign investors are subject to withholding tax at a flat 30-percent rate, which may be reduced by applicable treaty. Code Secs. 871(a)(1), 881; Reg. §1.871-1.

³⁴ Code Sec. 368.

³⁵ In order to make an election to be taxed under the Subchapter S rules of the Code, Form 2553 must be filed with the IRS within two months and 15 days after the S corporation's tax year begins. Code Sec. 1362(b)(1)(B), 1362(b)(2); Reg. §1.1362-6(a)(ii).

³⁶ However, S corporations may still be subject to (i) the tax on excessive passive investment income, (ii) the tax on built-in gains, and (iii) recapture of LIFO tax. See generally, Code Secs. 1362(d)(3), 1363(d) and 1374. Whether any implications with respect to these tax Code provisions will arise in the use of the S corporate entity structure will require further analysis and examination.

³⁷ Here, it is important to point out that state treatment may vary. In some states a federal S election automatically results in state S corporate treatment. In other states, the S corporation will be subject to the state income tax and will not pass its income up to its shareholders unless a separate state S election is filed. Here, it will be important to check respective state requirements.

³⁸ Although the S corporation operates as a conduit entity and is governed under the Code's Subchapter S rules, it is important to point out that Subchapter C provisions (i.e., C corporation tax provisions) will also apply to S corporations. Hence, in order to determine the tax consequences of particular transactions entered into by an S corporation, both Subchapter S and Subchapter C provisions will need to be examined.

³⁹ Code Sec. 1378.

⁴⁰ *Id.* Here, a natural business fiscal year end is allowed to be utilized provided that the S corporation "establishes a business purpose to the satisfaction of the Secretary" for the use of such year. Typically, the natural business year test is satisfied if during the three previous years, more than 25 percent of the gross business receipts are earned in the last two months of the selected fiscal year. See Rev. Rul. 87-57, 1987-2 CB 117.

⁴¹ Rev. Proc. 2002-38, 2002-1 CB 1037.

⁴² Code Sec. 444 provides that an entity may adopt or change its tax year to any fiscal year that does not result in a deferral period longer than three months or, if less, the deferral period of the year currently in use.

⁴³ Code Sec. 1361(b)(1).

⁴⁴ Code Sec. 1361(b)(2).

⁴⁵ Any stock that is owned by both a husband and wife is treated as owned by one shareholder. Code Sec. 1361(c)(1).

⁴⁶ Code Sec. 1361(c)(2).

⁴⁷ See generally, Code Sec. 1361(c).

⁴⁸ Code Sec. 1361(b)(1)(D).

⁴⁹ Reg. §1.1361-1(l)(1).

⁵⁰ *Id.*

⁵¹ Reg. §1.1361-1(1)(4)(iii)(A) and (iv).

⁵² Code Secs. 1366, 1367.

⁵³ Such debt/equity classification issues arise in situations where an S corporation is thinly capitalized. If thin capitalization of the entity occurs, then the S corporation will be viewed as having two classes of stock and S corporate status will be lost.

⁵⁴ Code Sec. 1361(c)(5).

⁵⁵ Failure to meet these requirements terminates the election and, as of the date of the termination, the S corporation is taxed as a C corporation. Code Sec. 1362(d)(2).

⁵⁶ Code Sec. 1362(g).

⁵⁷ See *supra* notes 13, 14 and 15 for a complete discussion of these requirements and the Code Sec. 351 requirements governing C corporations.

⁵⁸ Code Sec. 1363(c).

⁵⁹ Note that small business corporations, such as S corporations, typically employ some of their shareholders.

⁶⁰ Since such taxes are imposed on salaries received by shareholders of an S corporation, shareholders typically prefer to receive distributions from the S corporation rather than a salary for work performed for the entity. In such situations, the IRS has recharacterized all or part of a distribution as compensation and imposed employment taxes accordingly. See Rev. Rul. 74-44, 1974-1 CB 287.

⁶¹ Code Secs. 1366(a), 1377(a). Note the inflexibility of allocations made pursuant to stock ownership (i.e., items of net income or loss must be allocated to shareholders based on their stock ownership). Contrast this with partnerships and limited liability companies, both of which allow such items to be allocated in any manner decided by the parties.

⁶² Such tax treatment applies to both distributions of cash and property.

⁶³ Code Sec. 1368(b)(1).

⁶⁴ Code Sec. 1368(b)(2). Furthermore, Code Sec. 1202 (i.e., gain exclusion) and Code Sec. 1045 (i.e., tax-free rollover) are not available for S corporations. For a discussion of the tax advantages that may be generated by these Code provisions, see *supra* note 22.

⁶⁵ Note such tax treatment rests on the assumption that the S corporation has been

an S corporation from its inception. If the S corporation was ever a C corporation or if a C corporation was merged or liquidated into an S corporation then the tax treatment of an S corporation's distribution may vary depending on accumulated earnings and profits retained by the S corporation from the C corporation. See Code Sec. 1368(b), (c) and (e)(1). Distributions out of accumulated earnings and profits are treated as dividends and fully taxable as ordinary income to the shareholder. Code Sec. 1368(c)(2).

⁶⁶ Code Sec. 1366(d)(1).

⁶⁷ Code Sec. 1366(d)(2). Note that in addition to basis, a shareholder's ability to utilize losses may be limited due to the at-risk rule provisions under Code Sec. 465 and the passive activity rule provisions under Code Sec. 469. These provisions will not pose an obstacle for investors who are actively involved in the business of the entity.

⁶⁸ Code Secs. 1366(d)(1), 1367(a).

⁶⁹ Code Sec. 1361(b)(3)(B).

⁷⁰ A QSSS is treated as a disregarded entity under check-the-box regulations. Note that state taxation will vary, as some states do not recognize QSSS, do not recognize subchapter S status or treat a QSSS as a separate entity for franchise or excise tax purposes.

⁷¹ Passive investment income includes gross receipts from royalties, rents, dividends, interest, annuities and gains on sales or exchanges of stock or securities. Code Sec. 1362(d)(3)(C).

⁷² Code Sec. 1375(a).

⁷³ Code Sec. 1362(d)(3).

⁷⁴ Code Sec. 1374. Please note that this paragraph illustrates only some of the tax consequences that may result from a C corporation to an S corporation conversion. They are by no means an all-inclusive list. Tax counsel should be consulted for a more thorough analysis of the consequences attributable to such a conversion.

⁷⁵ In the case of a merger of a QSSS into an acquiring corporation or the merger of a target corporation into a QSSS, Code Sec. 368(a)(1)(A) is not apparently not available. Reg. §1.368-2(b).

⁷⁶ A Code Sec. 338(h)(10) election treats a subsidiary stock purchase by a parent corporation as an asset purchase, and as such, entitles the subsidiary to effectuate a step-up in the basis of all its assets. This in turn may lead to several advantages, such as greater depreciation expenditure amounts for the entity, which would serve to decrease the income of the entity and the taxes that it will owe.

⁷⁷ The discussion herein is applicable to both general partnerships and limited partnerships unless otherwise specified.

⁷⁸ Code Sec. 7701(a)(2).

⁷⁹ Code Sec. 761(a).

⁸⁰ Code Sec. 701. Whether partnership items of income, gain, deduction and loss are

properly treated for tax purposes is determined at the partnership level through unified audit proceedings. Code Sec. 6221. Here, it is important to point out that this flow through feature of partnerships does not guarantee that each partner will have enough cash on hand to pay the tax associated with partnership allocations, and as such, it may impact minority interest owners who do not have any control over the distributions of a partnership.

⁸¹ Code Sec. 702(a).

⁸² Code Sec. 446(c). See also exceptions set forth in Code Sec. 448.

⁸³ Code Sec. 706(a). Because a partner pays taxes on their allocations of partnership income made to them, subsequent distributions of these amounts are generally not taxable to the partner. Code Sec. 731(a).

⁸⁴ Code Sec. 706(b)(1)(B).

⁸⁵ Code Sec. 706(b)(1)(C).

⁸⁶ See Rev. Proc. 87-32, 1987-2 CB 396 and Rev. Rul. 87-57, 1987-2 CB 117. Additionally, like S corporations, partnerships may elect to use a tax year other than the ones discussed above, if the deferral period inherent in such year is no more than three months. See generally, Code Sec. 444. Note that special deposits of cash for tax liabilities may need to be set aside. Code Sec. 7519.

⁸⁷ Code Sec. 446(c). But see also, Code Sec. 448(a).

⁸⁸ A partnership having over 100 partners may be recharacterized as a publicly traded partnership under Code Sec. 7704, and as such, be taxed as a C corporation.

⁸⁹ A limited partnership must consist of one general partner bearing unlimited liability for the partnership's debts. Here, it is also important to point out that a corporate general partner may be utilized when dealing with a limited partnership. This would effectively achieve limited liability benefits comparable to a corporation with the caveat that it involves the complexity of two entities and some degree of risk that the corporation may be disregarded under the alter ego or piercing the corporate veil doctrines. Additionally, utilization of a limited partnership may result in additional costs as compared to that of a general partnership (e.g., special filing fees and/or tax on the net worth of the limited partnership at the entity level).

⁹⁰ Note that a limited partner who takes part in the control of the partnership business may become liable to the creditors of the partnership by doing so. Revised Uniform Limited Partnership Act (1976), § 303(a).

⁹¹ However, this may raise the costs associated with operating such an entity structure.

⁹² Code Sec. 709(b).

⁹³ Code Sec. 709(a).

⁹⁴ Code Sec. 704(a).

⁹⁵ Note if the IRS determines that partnership allocations do not satisfy Code requirements (i.e., lack substantial economic effect, etc.)

then partnership items are subject to reallocation by the IRS among the partners based on the partners' true economic interests in the entity as determined by the IRS.

⁹⁶ For a complete list of the requirements, see generally, Code Sec. 704.

⁹⁷ Code Sec. 721(a). Contrast with Code Sec. 721(b), (c) and (d). However, it is important to point out that if a partnership assumes a liability of a partner in connection with the contribution, the partner may be subject to tax if the liability is in excess of his or her basis in the partnership interest.

⁹⁸ However, if the interest is subject to a substantial risk of forfeiture so that the partner's rights in the interest are nonvested, Code Sec. 83(a) defers the recognition of income until the risk of forfeiture lapses. Partners who perform services in exchange for a restricted capital interest may elect to include the current value of the interest in gross income for the year of receipt. Code Sec. 83(b). However, a partner who eventually forfeits such capital interest back to the partnership may not claim a deduction for any unrecovered basis in the capital interest. Code Sec. 83(b)(1).

⁹⁹ Reg. §1.721-1(b)(1).

¹⁰⁰ Reg. §1.722-1.

¹⁰¹ The current consensus is that the service partner does not recognize current income upon the receipt of a profits interest because such interest has no immediate liquidation value. See, Rev. Proc. 93-27, 1993-2 CB 343 and Rev. Proc. 2001-43, 2001-2 CB 191. Thus, the service partner's basis in the interest is zero.

¹⁰² Note that guaranteed payments include such things as health insurance that are made available to the partners. See, e.g., Rev. Rul. 91-26, 1991-1 CB 184.

¹⁰³ Such payments like ordinary income are subject to self-employment tax. Code Sec. 1402(a). It is also important to point out that individual partners are required to make quarterly estimate payments of both the income tax and self-employment tax attributable to their distributive share of partnership income for the year. Code Sec. 6654.

¹⁰⁴ Code Secs. 162, 263.

¹⁰⁵ Reg. §1.707-1(c).

¹⁰⁶ Code Sec. 752(a).

¹⁰⁷ Code Sec. 733.

¹⁰⁸ Note that the at-risk and passive activity rules are applicable only to individual taxpayers and certain closely held corporations. They do not apply to losses allocated to corporate partners. Whether these provisions are applicable to your particular client should be an issue that is raised with your tax counsel.

¹⁰⁹ Any debt for which a partner is not personally liable is generally excluded from their at-risk amount. Code Sec. 465(b)(2)(A). However, exceptions exist concerning debt that qualifies as "qualified nonrecourse financing." See Code Sec.

465(b)(6)(B) for a complete discussion. Also, a partner's at risk amount with respect to a partnership is reduced by any partnership losses currently allowed as a deduction under Code Sec. 465(a). Code Sec. 465(b)(5). Clients should consult with their respective tax counsel for a complete calculation of at-risk amounts.

¹¹⁰Code Sec. 469(c)(2). Here it is important to point out that individuals, fiduciaries, closely held C corporations and personal service corporations are subject to the passive activity loss limitation. Code Sec. 469(a)(2). Additionally, suspended passive activity losses can be deducted in full in the year the partner disposes his/her entire interest in the activity. Code Sec. 469(g)(1). Whether an activity is a passive activity is subject to numerous tests, as outlined in Code Sec. 469 and the Regulations thereunder and will not be addressed herein.

¹¹¹Code Sec. 733.

¹¹²Code Secs. 732, 733.

¹¹³Here, it is important to note that partners are taxed on disproportionate distributions in which the recipient partner receives either more or less than a proportionate share of any partnership unrealized receivables or substantially appreciated inventory. See generally, Code Sec. 751(b), (c) and (d). Additionally, the disguised sale regulations can trigger unexpected gain recognition when partners contribute property to a partnership. Code Sec. 707. The tax consequences surrounding all proposed contributions and distributions of property into and out of a partnership should be analyzed.

¹¹⁴A blocker entity helps solve this problem but it also may lead to greater organizational and operational costs.

¹¹⁵See, e.g., Code Secs. 1441, 1446.

¹¹⁶Code Sec. 1202 (i.e., gain exclusion) and Code Sec. 1045 (i.e., tax-free rollover) are not available for partnerships.

¹¹⁷Code Sec. 708(b).

¹¹⁸Code Secs. 731, 351. *But see*, Code Sec. 357(c).

¹¹⁹Reg. §1.708-1(c)(3)(i).

¹²⁰Reg. §1.708-1(c)(3)(ii). In an "asset-up" transaction, the basis in the terminated partnership's asset basis is stepped up or down to the partners' outside basis. Code Sec. 732(b). In "assets-over" transaction, basis in terminated partnership's assets carries over to the resulting partnership. Code Sec. 723. A Code Sec. 754 election can ameliorate this difference.

¹²¹Reg. §301.7701-2.

¹²²The individual tax consequences attributable to each entity type will not be reiterated in this section. Rather, the discussion in this section will focus briefly the tax consequences that are specific to LLCs.

¹²³For example, a tax benefit attributable to being classified as a "disregarded entity" includes the avoidance of consolidated return regulations in situations where there are subsidiaries of a C corporate parent, etc.

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