Passing Through or Staying Awhile? C Corporations and Pass-Through Entities After Tax Reform

MATTHEW A. MELONE[*]

I. INTRODUCTION 398
II. REDUCTIONS OF TAX RATES 400
A. Pass-Through Entities, C Corporations, and Tax Rate Effects–In General 400
B. Effect of Other Provisions 410
1. State and Local Taxes 410
2. Restrictions on Interest Expense 411
3. Expensing of Capital Improvements 412
4. Deduction for Pass-Through Income 412
III. CONVERSION TO A C CORPORATION 419
A. S Corporation to C Corporation 420
B. Conversion of Partnership to C Corporation 422
IV. RECONVERSION TO PASS-THROUGH STATUS 433
A. S Corporation vs. Partnership 433
B. Loss of Partnership Advantages 435
1. Book-Tax Disparities 436
2. Capital Structure 437
3. Exit Strategies 441
4. S Corporation Advantages 443
V. CONCLUSION 446

* J.D., University of Pennsylvania; Professor of Law, Lehigh University, Bethlehem, Pennsylvania.

> Who pays the business tax anyway? *We do! You* can't tax business. Business doesn't *pay* taxes. It *collects* taxes.[±]
>
> Ronald Reagan

I. INTRODUCTION

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act into law.[1] This legislation enacted deep cuts in the corporate income tax rate, provided comparatively minor reductions in individual income tax rates, reformed the taxation of income earned from foreign sources, and made changes throughout the Internal Revenue Code ("I.R.C.") that will affect, to some extent, all taxpayers.[2] Expectedly, the legislation did not have bipartisan support—not one Democrat in either the House or Senate voted for the measure. The belief that many of its provisions rest on a shaky political foundation is warranted.[3]

The combination of a large corporate tax rate reduction and relatively minor reductions in the individual tax rates has made the C cor-

---

± Interview by Manuel S. Klausner with Ronald Reagan, Former Governor of Cal., in L.A., Cal., 1, at 4 (July 1975), http://reason.com/archives/1975/07/01/inside-ronald-reagan/.

1. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054. The final version of the legislation is unwieldly titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." *Id.* This Article refers to the Act by its commonly used title.

2. Unless otherwise noted all references to statutory sections are to sections of the Internal Revenue Code of 1986 ("I.R.C."), as amended, including any amendments made by the Tax Cuts and Jobs Act.

3. The Senate vote was 51 yeas and 48 nays. One Senator did not vote. Not one Democratic Senator voted yea. Tax Cuts and Jobs Act of 2017, Senate Vote on H.R. 1, 115th Cong. (1st Sess. 2017), https://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=115&session=1&vote=00323#top. The vote in the House of Representatives was 224 yeas and 201 nays. Seven members did not vote. Not one Democratic member voted yea. Tax Cuts and Jobs Act of 2017, House Vote on H.R. 1, 115th Cong. (2017), http://clerk.house.gov/evs/2017/roll699.xml.

poration an attractive vehicle in which to conduct a closely-held business.[4] The corporate form's tax disadvantages have not been eliminated, but the disparity in tax rates between corporations and individuals may prompt taxpayers to reassess whether these disadvantages are now a reasonable price to pay for the tax savings that may be realized in the corporate setting. Consequently, taxpayers who currently operate their businesses in a pass-through form, most commonly through partnerships, limited liability companies ("LLCs"), and S corporations, may consider operating their businesses as C corporations.[5]

Part II of this Article discusses and analyzes the tax effects of the corporate and individual income tax rate reductions. These rate reductions cannot be viewed in isolation. Numerous provisions of the new law will either heighten or diminish the tax rate advantage now enjoyed by C corporations. One such provision, the deduction for pass-through income, has particular relevance in this respect and is examined in detail. Generalizations about the effects of the rate cuts are difficult—and unwise—because such effects are highly fact dependent. Projected income, the extent of owner participation in the business, and the ability and desirability of earnings retention in the business are among the more salient variables to be considered.

Part III of this Article examines the immediate tax consequences for a business entity that changes form. Least consequential is a change from S corporation to C corporation status. Partnerships and LLCs must consider the possibility that a conversion to the corporate form will result in the immediate recognition of gain. Moreover, for these entities that have creative equity structures in place, a change to corporate status could require revisions of those structures.

Part IV considers the possibility that the advantages of the corporate form prove to be ephemeral—a distinct possibility in the event of a shift in power among the political parties. Partnerships and LLCs

4. The term "C corporation" refers to a corporation which is subject to tax on its income under general corporate tax principles. The term is derived from Subchapter C of Chapter 1 of the I.R.C., the subchapter that contains the general corporate income tax provisions. *See infra* notes 20–33 and accompanying text.

5. The term "S corporation" refers to a corporation whose income, with few exceptions, is not subject to corporate tax. Instead, its income is taxed directly to the corporation's shareholders. The term is derived from Subchapter S of Chapter 1 of the I.R.C., the subchapter that contains the rules applicable to such corporations. *See infra* notes 15–19 and accompanying text.

must be cognizant that a conversion to C corporation status may result in a permanent loss of the tax advantages unique to entities that are taxed under partnership rules. This Part discusses these advantages and the circumstances in which these advantages may be too costly to reacquire due to general principles of corporate taxation. Consequently, future pass-through status will generally be accomplished using an S corporation. Although the conversion from C corporation status to S corporation status is relatively simple, it is not without cost. Even entities that originally were S corporations prior to conversion will find that the status quo ante is not restored.

The fragile political foundation on which the Tax Cuts and Jobs Act rests should give taxpayers pause before leaping at the opportunity to cut their tax bill. Due diligence is critical in determining the extent of any benefits that may be realized by a change in an entity's tax status. The costs of conversion and the possibility that such benefits may be short-lived must be considered. Partnerships and LLCs may very well find that the benefits of incorporation are short-lived, but the loss of partnership tax benefits is enduring.

II. REDUCTIONS OF TAX RATES

The Tax Cuts and Jobs Act significantly reduced the corporate tax rate. Tax rate reductions for other taxpayers were, by comparison, relatively modest. Consequently, great disparities in tax burden may result depending upon whether a corporate taxpayer or an individual taxpayer incurs the tax on taxable income. These disparities have raised the possibility that taxpayers who have conducted their business using pass-through entities could change course and conduct their business through a C corporation. Typical of most choices regarding taxation, the desirability of a particular form of entity in which to conduct business is fact dependent.

A. Pass-Through Entities, C Corporations, and Tax Rate Effects–In General

There are numerous forms of pass-through entities—entities whose taxable income is wholly or partially taxed at the owner's level, and their income, to the extent so taxed, is not taxed at the entity level.

Partnerships, LLCs, trusts, estates, S corporations, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, and certain cooperatives are pass-through entities.[6] Partnerships, LLCs, and S corporations are the pass-through forms generally employed to conduct business.[7] Multi-member LLCs, absent an election to the contrary, are treated as partnerships for federal income tax purposes; unless otherwise noted, any reference to partnerships and partners is also a reference to LLCs and members of LLCs.[8]

For federal income tax purposes, a partnership is not a taxpaying entity.[9] Instead, partnership income, gains, deductions, and losses are passed through to the partners.[10] The character of the partnership's income tax items are retained at the partner level, and any item that

---

6. The pass-through feature of these entities is accomplished in different ways. For example, trusts, estates, regulated investment companies, real estate investment trusts, and cooperatives attain pass-through status by virtue of distributions. S corporations and partnerships simply pass-through entity level items to their shareholders and partners, respectively. *See infra* notes 9–16 and accompanying text. Except for partnerships, none of these entities enjoy blanket exemption from income taxation, however. *See generally* I.R.C. §§ 641–691, 851–860, 860A–860G, 1361–1378, 1381–1388 (2012 & Supp. 2018). Publicly traded partnerships are taxed as corporations unless they derive 90% or more of their gross income from certain passive activities such as interest, dividends, rents, and certain natural resource activities. *See* I.R.C. § 7704 (2012).

7. A sole proprietorship is not an entity separate and distinct from its owner, and its income is taxed directly to its owner. Single-member LLCs, absent an election to the contrary, are treated as sole proprietorships for federal income tax purposes. *See infra* note 8.

8. LLCs elect, under the so-called check-the-box regulations, to be taxed as corporations. Treas. Reg. § 301.7701-3(a) (2006). Moreover, single-member LLCs are ignored for federal income tax purposes unless such entities elect to be taxed as corporations. *See* Treas. Reg. § 301.7701-2(a) (2016); Treas. Reg. § 301.7701-3(a) (2006). All transactions of such LLCs are accounted for as if transacted directly by the member. *See* Treas. Reg. § 301.7701-2(a) (2016); Treas. Reg. § 301.7701-3(a) (2006).

9. I.R.C. § 701 (2012). Partnerships are responsible for employment and excise taxes. *See, e.g.*, I.R.C. § 3401 (2012 & Supp. 2018); Treas. Reg. § 31.3401(d)-1(c) (1970) (stating that an employer may be a partnership). In the event the partnership does not discharge its obligations for such taxes, the general partners may be held responsible either under general state law principles or, if applicable, specific statutory provisions. *See* I.R.C. § 6672 (2012 & Supp. 2018) (imposing liability for employment taxes on certain responsible persons).

10. I.R.C. § 702(a) (2012).

may have an effect on a partner's income tax liability must be separately stated.[11] Accordingly, a partnership is treated as an aggregate of its partners and not as an entity distinct from those partners.[12] The tax basis of a partner's interest in the partnership is adjusted upward for the partner's share of income and capital contributions and downward for the partner's share of losses and distributions.[13] A partner's tax

---

11. *See* I.R.C. § 702(b) (2012); Treas. Reg. § 1.702-1(a) (2005). For example, deductions that are, or may be, subject to limitation at the partner level must be separately passed through to the partner and subjected to the limitations that may exist at such level. Examples of such items include investment income, investment interest expenses, passive activity gains and losses, capital gains and losses, charitable contributions, foreign taxes, and alternative minimum tax adjustments and preferences. *See generally* Treas. Reg. § 1.702-1(a)(1)–(8) (2005). Attempts to apply an aggregate theory to prevent the use of partnerships from subverting the application of tax accounting rules often lead to administratively burdensome solutions. *See, e.g.*, I.R.S. Notice 88-99, 1988-2 C.B. 422 (requiring that partnerships report to partners their share of interest expense and capital expenditures for purposes of determining whether the partner must capitalize interest).

12. In other respects, an entity theory of partnerships underlies the tax rules. This duality is not limited to the application of income tax rules and permeates other provisions of the I.R.C. *See generally* Alfred D. Youngwood & Deborah B. Weiss, *Partners and Partnerships—Aggregate vs. Entity Outside of Subchapter K*, 48 TAX LAW. 39 (1994). For example, the partnership must file a tax return, and accounting periods and methods are selected by the partnership. Such periods and methods determine the timing and amount of the partners' distributive share of partnership items. *See* I.R.C. § 703 (2012); I.R.C. § 706(b) (2012 & Supp. 2018). Elections with respect to cancellation of indebtedness income, mining exploration expenditures, and foreign taxes, however, are made by the partners. I.R.C. § 703(b)(1)–(3) (2012). Because the tax year of the partnership determines the time in which partners must report their share of partnership items, partnerships are limited in their choice of tax year and generally must select a tax year by referencing the tax years of its partners. I.R.C. § 706(b)(1)(B) (2012 & Supp. 2018). *But see* I.R.C. § 444 (2012) (providing an election to select a tax year that would result in a tax deferral of no more than three months). A partner may also deal with the partnership in a non-partner capacity and will be taxed accordingly. *See* I.R.C. § 707(a) (2012). Moreover, the partner's interest in the partnership is a separate asset, much like a share of stock. A partnership interest is a capital asset and will, upon taxable disposition, result in a capital gain or loss. I.R.C. § 741 (2012). *But see* I.R.C. § 751(a) (2012 & Supp. 2018) (requiring that, to the extent the amount realized by the transferor is attributable to certain types of assets held by the partnership, the amount realized is not considered to be from the sale or exchange of a capital asset).

13. *See generally* I.R.C. §§ 705(a), 722, 723, 731 (2012).

basis in her partnership interest includes her share of partnership debt, including nonrecourse debt of the partnership.[14]

Similar rules apply to S corporations and their shareholders.[15] There are, however, significant differences between the taxing schemes applicable to partnerships and S corporations. Most notably are the inability of S corporation shareholders to include corporate debt in the tax basis of their shares and the rigidity in which items of the corporation must be allocated among S corporation shareholders.[16] Moreover, unless the subchapter S rules provide otherwise, an S corporation is subject to the tax rules that apply to corporations in general.[17] As discussed subsequently, the partnership form is preferable to S corporations in most, but not all, respects.[18] The differences between these two forms should be carefully considered in the decision

14. An increase in a partner's share of partnership liabilities is treated as a contribution of money to the partnership by the partner, and correspondingly, a decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner. I.R.C. § 752(a)–(b) (2012). Recourse liabilities are liabilities of the partnership to the extent that a partner or related person bears the economic risk of loss for that liability. Treas. Reg. § 1.752-1(a)(1) (2005). Recourse liabilities are allocable to those partners that bear the risk of loss, which would typically be the general partners. Treas. Reg. § 1.752-2(a) (2016). A nonrecourse liability is a partnership liability for which no partner or related party bears the economic risk of loss. Treas. Reg. § 1.752-1(a)(2) (2005). These liabilities are allocated under special rules that, in part, reflect the amount of gain that would be allocated to the partners in the event the partnership property was sold in satisfaction of such liabilities. *See* Treas. Reg. § 1.752-3 (2017); *see also infra* note 106 and accompanying text. The ability to include the entity's debt in basis underpinned the use of partnerships as tax shelter vehicles. A partner's distributive share of partnership losses may not exceed that partner's basis in her partnership interest. I.R.C. § 704(d) (2012 & Supp. 2017). Because a partner's tax basis includes her share of partnership debt, a partner has a greater basis with which to absorb losses than, for example, a shareholder in an S corporation who is subject to a similar rule but cannot include the corporation's debt in basis. *See* I.R.C. § 752 (2012); I.R.C. § 1366(d)(1) (2012 & Supp. 2018). An S corporation shareholder may deduct losses to the extent of her basis in the corporation's stock and debt owed by the corporation to the shareholder. I.R.C. § 1366(d)(1)(B) (2012 & Supp. 2018).

15. *See generally* I.R.C. § 1363 (2012); I.R.C. § 1366 (2012 & Supp. 2018); I.R.C. § 1367 (2012 & Supp. 2015); I.R.C. § 1368 (2012 & Supp. 2018).

16. *See* I.R.C. § 1366(a) (2012 & Supp. 2018) (requiring that S corporation items be allocated pro-rata among the shareholders of the corporation); *supra* note 14.

17. I.R.C. § 1371(a) (2012 & Supp. 2017).

18. *See infra* notes 136–73 and accompanying text.

to convert an entity into a C corporation for tax purposes because a decision to reconvert to pass-through status will likely be accomplished through an S corporation and not a partnership.[19]

In contrast, a C corporation is a taxpaying entity and repatriation of its earnings to its shareholders is taxed separately to its shareholders.[20] Prior to 2018, the corporate income tax rate was 35%, and the highest rate of tax imposed on qualified dividends received by an individual taxpayer was 23.8%.[21] Consequently, if a C corporation distributed all its after-tax earnings to shareholders in the form of dividends, the effective tax rate on corporate earnings could have been as high as 50.5%.[22] Corporations could structure their affairs to ensure

---

19. *See infra* notes 124–29 and accompanying text.

20. *See* I.R.C. § 61(a)(7) (2012 & Supp. 2017). Distributions to shareholders are taxable dividends to the extent such distributions are from the current or accumulated earnings and profits of the corporation. Distributions in excess of earnings and profits are a return of capital to the shareholder and, to the extent they exceed the shareholder's tax basis in her stock, result in a gain from the sale or exchange of such stock. *See* I.R.C. § 301(c) (2012 & Supp. 2014); I.R.C. § 316(a) (2012).

21. *See* I.R.C. §§ 1(h)(11), 11(b) (2012 & Supp. 2017) (amended effective for tax years beginning in 2018). The income tax rate on dividends varied from 0% to 20% depending on the individual's taxable income level. *See* I.R.C. § 1(h)(1) (2017) (amended effective for tax years beginning in 2018). Effective in taxable years beginning in 2013, an Unearned Income Medicare Contribution of 3.8% is imposed on individuals, estates, and trusts on the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount. I.R.C. § 1411 (2012). See *infra* note 26 and accompanying text for a discussion of the Unearned Income Medicare Contribution.

22. Assume TI is the corporation's taxable income. The corporate tax on such earnings is .35TI and the corporation's after-tax income is .65TI. The distribution of after-tax earnings to individual shareholders would result in a tax to the shareholders of .1547TI (.65TI x .238). The total tax imposed on TI is 50.47% of TI. The assumption of the highest marginal rate of tax on the dividend recipients ignores any effects of the plethora of rules that phase-out certain tax benefits based on the individual's income. Various deductions and credits could be reduced or eliminated as income increases. In many, if not most, situations, as income reaches certain levels, the phase-outs have been completed, and additional income has no effect on deductions or credits. A detailed discussion of these provisions is beyond the scope of this work. See *How Do Phaseouts of Tax Provisions Affect Taxpayers*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/how-do-phaseouts-tax-provisions-affect-taxpayers (last visited Jan. 18, 2019), for a general overview of the items subject to phase-out.

that a portion of their earnings was paid out to shareholders as compensation, rent, or some other such deductible expense, but the utility of such arrangements is often limited.[23] Alternatively, the corporation could retain its earnings—not without limit—if the shareholders had no need for distributions.[24]

Prior to 2018, the highest marginal income tax rate for individuals, estates, and trusts was 39.6%.[25] If the 3.8% Unearned Income Medicare Contribution—a tax that is applicable to income earned from trades or businesses in which the taxpayer does not materially participate—applied, then the highest effective marginal tax rate on such persons was 43.4%.[26] Beginning in 2018 and ending after 2025, the highest marginal income tax rate for individuals, estates, and trusts is

---

23. A corporation may deduct compensation paid only to the extent it is reasonable. Treas. Reg. § 1.162-7 (1958). Excessive compensation paid to shareholders is considered to be a dividend. Treas. Reg. § 1.162-8 (1958). Therefore, it may not be possible to strip corporate earnings through compensation payments if employment of physical capital or human resources generates a significant amount of income. This strategy is most easily employed when shareholder efforts principally derive the corporate earnings.

24. A tax on accumulated earnings is imposed on corporations that are formed or availed of to avoid the income tax with respect to their shareholders by permitting earnings to be accumulated beyond a modest credit amount and the reasonable needs of the business. *See generally* I.R.C. §§ 531–535 (2012 & Supp. 2017); I.R.C. § 536 (2012); I.R.C. § 537 (2012 & Supp. 2017). Also, an additional tax is imposed on corporations that are classified as personal holding companies. I.R.C. § 541 (2012 & Supp. 2013). In general, such classification is limited to certain closely-held corporations that derive at least 60% of their gross income from certain passive sources. *See generally* I.R.C. §§ 541–43 (2012 & Supp. 2018); I.R.C. § 544 (2012); I.R.C. § 545 (2012 & Supp. 2017); I.R.C. §§ 546–47 (2012).

25. I.R.C. § 1(a)–(e) (2012 & Supp. 2017) (amended effective for tax years beginning in 2018). This marginal rate ignores the application of numerous phaseout provisions. *See supra* note 22.

26. The tax base on which the Unearned Income Medicare Contribution is imposed is the lesser of net investment income or the excess of modified adjusted gross income over a threshold amount. I.R.C. § 1411(a)(1) (2012). The threshold amounts for individuals are $250,000 for surviving spouses and taxpayers filing a joint return, $125,000 for married taxpayers filing separate returns, and $200,000 for all other individual taxpayers. I.R.C. § 1411(b) (2012). The I.R.C. defines net investment income as "gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business . . . [;] other gross income derived from a trade or business" that is either a passive activity under § 469 or constitutes the trading of financial instruments or commodities; and

37%.[27] The new legislation did not disturb the 3.8% Unearned Income Medicare Contribution. Therefore, income from pass-through entities in which the taxpayer does not materially participate could be subject to effective marginal tax rates of 40.8%.[28]

"net gain attributable to the disposition of property other than property held in a trade or business" that is neither a passive activity nor constitutes the trading in financial instruments or commodities. I.R.C. § 1411(c) (2012). Income subject to self-employment tax is not subject to this tax. *Id.* § 1411(c)(5). See *infra* notes 170–73 and accompanying text, for a discussion of the self-employment tax. Whether a trade or business is a passive activity is determined at the owner level. Treas. Reg. § 1.1411-5(b)(1) (2014).

27. I.R.C. § 1(j)(1)–(2) (2012 & Supp. 2017). This marginal rate ignores the application of numerous phase-out provisions. *See supra* note 22. If income is subject to employment taxes, then the amount of such taxes will increase the effective tax rate. The Medicare portion of employment taxes is not subject to any earnings limitations; therefore, high-income individuals will face an additional tax of 2.35%, including the .9% additional tax, on wage income and 3.8%, including the .9% additional tax, on income from self-employment. Because one-half of the tax imposed on self-employed individuals, excluding the additional .9 tax, is deductible, the effective tax rate for such individuals is increased by 3.26% (.038 - (.37 x .0145)) as a result of the imposition of the Medicare portion of this tax. *See* I.R.C. § 164(f) (2012 & Supp. 2017). See *infra* notes 169–73 and accompanying text, for a discussion of employment taxes.

28. The material participation rules set forth in Temporary Treasury Regulation § 1.469-5T determine whether the taxpayer derives gross income from a passive activity. *See* Temp. Treas. Reg. § 1.469-5T(a)(1)–(7) (1992). Those regulations enumerate seven situations in which a taxpayer is deemed to materially participate in an activity, including the 500-hour rule, the 100/500-hour significant participation rule, and a catch-all facts and circumstances test. *Id.* Under I.R.C. § 469(h)(2) losses derived from an interest in a limited partnership as a limited partner are presumptively passive. I.R.C. § 469(h)(2) (2012 & Supp. 2018). Limited partners, however, are deemed to materially participate in an activity, and therefore rebut the statutory presumption of passivity only if they meet a 500-hour test, have materially participated in personal service activities for any three taxable years preceding the taxable year, or have materially participated in an activity in five of the previous ten years. Temp. Treas. Reg. § 1.469-5T(e)(2) (1992). The I.R.S. has been unsuccessful in its attempts to classify interests in LLCs as limited partnership interests for passive activity loss purposes. In 2009, the Tax Court held that the *per se* rule of § 469(h)(2) does not apply to membership interests in LLCs or to partnership interests in limited liability partnerships. Garnett v. Comm'r, 132 T.C. 368, 381–83 (2009). The Tax Court held similarly in two later cases as did the Court of Federal Claims. *See* Newell v. Comm'r, 99 T.C.M. (CCH) 1107 (2010); Hegarty v. Comm'r, No. 3730-07S, 2009 T.C. LEXIS 154 (T.C. Oct. 6, 2009) (summary opinion); Thompson v. U.S., 87 Fed. Cl. 728 (Fed. Cl. 2009). The I.R.S. has acquiesced, in result only, in the 2009 Court of Federal

Effective for taxable years beginning after 2017, the corporate income tax rate is 21%.[29] Consequently, if a C corporation distributes all its after-tax earnings in 2018 to shareholders in the form of dividends, then the effective tax rate on corporate earnings could be as high as 39.8%.[30] Therefore, the corporate and individual tax rate reductions reduce the highest marginal tax rate on distributed corporate earnings from 50.5% to 39.8%.[31]

The corporate form has become an attractive vehicle for the accumulation of earnings. The difference between corporate and individual marginal tax rates in 2018 could be as high as 19.8%.[32] In 2017, this difference was markedly less—8.6% at a maximum—and for most taxpayers hardly worth the potential tax costs if dividends were to be paid or other negative tax features of the corporation form were to become salient.[33]

Moreover, the corporate tax rate reduction enhances the attractiveness to corporate employers of temporarily accumulating earnings using deferred compensation arrangements. Compensation that is deferred under a nonqualified deferred compensation plan that meets certain statutory design and operational requirements is taxable to the recipient when actually or constructively received and, concomitantly,

---

Claims decision, *Thompson v. United States,* and issued proposed regulations in 2011 that treat a membership interest as a limited partner interest for purposes of § 469 only if the membership interest in question carries no rights to manage the entity at any time during the taxable year. I.R.S. Chief Couns. Mem. 2010-14 (Apr. 5, 2010), https://www.irs.gov/pub/irs-aod/aod201002.pdf; Prop. Treas. Reg. § 1.469-5(e), 76 Fed. Reg. 72,875 (Nov. 28, 2011).

29. I.R.C. § 11(b) (2012 & Supp. 2017). The corporate alternative minimum tax has been repealed effective for taxable years beginning after 2017. *See id.* § 55(a).

30. Assume TI is the corporation's taxable income. The corporate tax on such earnings is .21TI, and .79TI is the corporations' after-tax income. If .79TI is distributed to the individual shareholders of the corporation, a tax of .188TI (.79TI x .238) would be imposed on such shareholders. The total tax imposed on TI is 39.8% of TI. The assumption of the highest rate of tax on the dividend recipients ignores any effects of the myriad of rules that phase-out certain tax benefits based on the income levels. *See supra* note 22.

31. *See supra* note 22 and 30.

32. This figure represents the difference between the 21% corporate tax rate and the sum of the 37% income tax rate and the 3.8% Unearned Income Medicare Contribution.

33. *See supra* notes 12–24 and accompanying text for the tax consequences incident to a corporate liquidation.

deductible by the employer at that time.[34] For the employer, whether a deferred deduction for compensation is preferable to an immediate deduction for such compensation depends primarily on the employer's current and expected marginal tax rates and the after-tax rates of return on employer capital.[35] Marginal tax rates that are expected to rise in the future will favor deferral, all things being equal. Because deferred compensation represents, in essence, a loan from the employee to the employer, an employer will benefit from the deferral of compensation if, all things being equal, the employer earns a greater return on the funds retained than the return the employer must pay the employee on the retained funds.[36]

---

34. *See* I.R.C. § 404(a)(5) (2012). The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885(a), 118 Stat. 1418, 1634–41 (2004), added § 409A to the I.R.C. to curb deferred compensation practices that were perceived as abusive. The statute imposes certain operational and design requirements on deferred compensation plans within its scope. The statute has a broad reach encompassing any plan, other than those specifically exempted, that provides for the deferral of compensation. *See* I.R.C. § 409A(d)(1)–(2) (2012 & Supp. 2018). Section 409A(a)(1) requires that all compensation deferred under the plan for the taxable year and all preceding taxable years be included in gross income during the taxable year in which the deferred compensation plan fails to meet the requirements specified in the statute. *Id.* § 409A(a)(1), (d)(5). Moreover, interest is imposed on the amount of compensation included in gross income pursuant to this provision in addition to a 20% penalty on the amount so included. *Id.* § 409A(a)(1)(B)(i). Qualified plans include pension, profit sharing, and stock bonus plans that meet a host of strict requirements including broad participation and nondiscrimination rules. The timing of employer deductions for contributions to such plans is subject to other rules, a discussion of which is beyond the scope of this work. *See generally id.* §§ 401–404.

35. From an employee's perspective, the decision whether to defer income to later years generally is dependent on liquidity considerations and expectations about future tax rates. In addition, the employee assumes credit risk with respect to the compensation deferred because her claim to such compensation is a claim of a general creditor of the firm. Placing the assets to fund such compensation outside the reach of the firms' creditors exposes the deferred compensation's recipient to immediate taxation under the doctrine of constructive receipt. *See* Treas. Reg. § 1.451-2(a) (1979).

36. For example, assume that an employer can pay an employee $100,000 in a cash bonus or defer the bonus for three years with a 6% rate of return, and the current and expected future corporate tax rate is 21%. The immediate payment of the compensation would cost the employer $79,000 after-tax ($100,000 x (1-.21)). Deferred compensation would result, three years hence, in a compensation payment of $119,102 ($100,000 x 1.06^3) and an after-tax cost to the corporation of $94,091

The reduction in the corporate tax rate has two effects in this respect.[37] First, it increases the after-tax cost of compensation; therefore, it strengthens the case for deferral if the employer can earn a greater rate of return on the funds than the return promised to the employee.[38] Second, deferred compensation will function as a hedge against future corporate tax rate increases.[39] It is unlikely that corporate rates will be lower in the future but, given the partisan nature of support for the tax legislation, such rates may very well be increased in the future.

($119,102 x (1-.21)). Assuming the corporation earned 8% after-tax on the cash savings that resulted from the decision to defer the compensation, the $79,000 in cash generated from the deferral of the compensation would grow to $99,517 ($79,000 x 1.08^3). Thus, the three-year deferral results in a net after-tax benefit to the corporation of $5,426 ($99,517-$94,091).

37. The reduction in individual tax rates, including the reduction caused by the deduction for pass-through entities discussed at *infra* notes 51–70 and accompanying text, has the same effect for pass-through entities that utilize deferred compensation arrangements to compensate their non-owner employees. However, because the rate reductions for individuals are not as great as the rate reduction for corporations, the effect is less pronounced for owners of pass-through entities than it is for corporate taxpayers.

38. For example, the same facts presented in *supra* note 36 would yield less benefit to the corporation if the corporate tax rate was 35% instead of 21%. This is because the after-tax cost of the bonus payment would be $65,000 instead of $79,000, thereby providing the corporation with less savings on which to earn a greater rate of return. Deferred compensation would result, three years hence, in a compensation payment of $119,102 ($100,000 x 1.06^3) and, at a 35% tax rate, an after-tax cost to the corporation of $77,416 ($119,102 x (1-.35)). Assuming the corporation earned 8% after-tax on the cash savings that resulted from the decision to defer the compensation, the $65,000 in cash generated from the deferral of the compensation would grow to $81,881 ($65,000 x 1.08^3). Thus, the three-year deferral results in a net after-tax benefit to the corporation of $4,465 ($81,881-$77,416), approximately 18% less than the benefit attained at a 21% corporate tax rate as set forth in *supra* note 36.

39. For example, assume the same facts set forth in *supra* note 38. Assume further that the corporate tax rate is increased to 30% in three years, the time at which the deferred compensation is paid. All the figures in that example remain the same except that the compensation payment's after-tax cost in year three would decrease to $83.371 ($119,102 x (1-.3)) from $94,091.

B. Effect of Other Provisions

Other provisions of the Tax Cuts and Jobs Act could diminish or enhance the advantages of the corporate form. Their effects should be analyzed and factored into the decision of which business form is most desirable. Among the more important provisions that could enhance the desirability of the corporate form are the limited deductibility of state and local taxes by individuals and new restrictions on the deductibility of interest expense. In contrast, the extension and enhancement of the ability to expense capital improvements and the new deduction for income generated from pass-through entities mitigate the advantages provided to corporations by the new tax rates.

1. State and Local Taxes

For taxable years 2018 through 2025, individuals who itemize their deductions may only deduct up to $10,000 in state and local income and property taxes.[40] Consequently, the state and local income taxes imposed on income derived through a pass-through entity may provide little or no federal tax benefit. Such taxes, if imposed on a corporation, would reduce the taxable income of the corporation.[41] Tax rates that are substantially higher for corporations compared to those applicable to individuals will overwhelm any advantages provided by the ability to deduct such taxes.[42]

40. I.R.C. § 164(b)(6) (2012 & Supp. 2017). State and local real property or personal property taxes incurred in a trade or business or an activity entered into for profit are not subject to this limitation. *Id.*

41. The limitation discussed at *supra* note 40 and accompanying text, applies only to individuals who itemize their deductions.

42. For example, a state corporate tax rate of 10% would result in a net tax rate, after the federal tax deduction, to the corporation of 7.9% (.10 - (.21 x .10)). Although the state tax is deductible by the corporation, if the individual state tax rate is less than 7.9%, then shifting the incidence of tax to the corporation is costly. Generalizations as to the relative state tax advantages of a particular form of entity should be made with caution. At the entity level, the issues that must be examined include whether the state in question treats S corporations and LLCs as pass-through entities, whether corporate taxes are imposed on capital stock or other non-income base, and whether an S election may be made for LLCs taxed as corporations for state tax purposes. At the equity owners' level, a different set of issues should be addressed. States vary in their treatment of partnership interests and S corporation stock for purposes of establishing nexus. Owners who otherwise would not have sufficient nexus

2. Restrictions on Interest Expense

Effective for taxable years beginning in 2018 for taxpayers whose three year average annual gross receipts exceed $25 million, the deduction for business interest expense is limited to the sum of business interest income and 30% of the taxpayer's adjusted taxable income.[43] Interest expense that is disallowed by this provision is treated as interest paid or accrued in the succeeding taxable year.[44] Business interest expense is interest paid or accrued on indebtedness allocable to a trade or business.[45] With respect to partnerships and S corporations, the limitation is first applied at the entity level and special rules increase a partner's or shareholder's deduction limit in the event that the entity has excess income.[46] For tax years beginning before 2022, depreciation, amortization, and depletion deductions will not reduce adjusted taxable income.[47] Thus for entities subject to this interest deduction limitation, taxable income will increase thereby increasing the lower corporate tax rate's attractiveness. Partnerships offer some pos-

---

to be subject to a jurisdiction's tax may find that their ownership in a pass-through entity creates such a nexus. Finally, owners should not dismiss as inconsequential the administrative burdens of holding an interest in a pass-through entity operating in multiple jurisdictions.

43. I.R.C. § 163(j)(1)(A)–(B), (j)(3) (2012 & Supp. 2018). The gross receipts exception references the test set forth in I.R.C. § 448(c) that entitles certain entities to use the cash receipts and disbursements method of accounting. The gross receipts limitation has increased to $25 million from $5 million. *See* I.R.C. § 448(c)(1) (2012 & Supp. 2017). Gross receipts of related parties are aggregated for this purpose. *See id.* § 448(c)(2). Floor plan financing by dealers of motor vehicles and certain other types of property is fully deductible. I.R.C. § 163(j)(1)(C), (j)(9) (2012 & Supp. 2018). This provision does not apply to interest incurred as an employee or to interest incurred by certain utilities. *Id.* § 63(j)(7)(A)(i), (iv). Certain real estate and farming operations may elect to avoid the application of this provision at the cost of depreciating property over less favorable recovery periods. *Id.* § 163(j)(7)(A)(ii)–(iii), (j)(7)(B), (g)(1)(F)–(G).

44. I.R.C. § 163(j)(2) (2012 & Supp. 2018).

45. *Id.* § 163(j)(5).

46. *Id.* § 163(j)(4)(A)(i), (j)(4)(B)(ii)(I).

47. *Id.* § 163(j)(8)(A)(v).

sibilities in mitigating this limitation's effect in certain situations; although, until guidance is issued by the I.R.S., the reality of such possibilities remains uncertain.[48]

3. Expensing of Capital Improvements

Among the provisions that reduce the corporate form's advantages are the allowance of an immediate deduction for certain capital investments and the deduction for earnings derived from pass-through entities. The legislation extended the ability to expense certain capital investments from 2019 to 2026 and increased the percentage of such investments that may be expensed to 100% from 40%.[49] This percentage scales down beginning in 2023 and is completely phased-out for property placed in service after 2026.[50] This provision will have the effect of reducing taxable income, thereby diminishing the lower corporate tax rate's effects.

4. Deduction for Pass-Through Income

Effective for taxable years beginning in 2018 and before 2026, taxpayers other than corporations are allowed a deduction for a portion

---

48. The statute defines business interest as interest paid or accrued with respect to indebtedness allocable to a trade or business. *See supra* note 45. Capital contributing partners in a partnership are commonly provided guaranteed payments for the use of capital. It is uncertain whether such guaranteed payments will be treated as interest expenses for this purpose. If not, it is possible to restructure debt as a capital interest subject to a guaranteed payment to avoid applying the limitation to such payments. Regulations deal with guaranteed payments for the use of capital for purposes of the passive activity loss rules and treat such payments, for that purpose, similarly to interest income. *See* Treas. Reg. § 1.469-2(e)(2)(ii) (1993). If a similar approach is taken for this purpose, it may be possible to structure payments for capital as a form of preferred return with priority over other distributions. However, the replacement of a legal obligation to make payments with a mere priority right substantially changes the economics of the arrangement.

49. I.R.C. § 168(k)(1)(A), (k)(5)(A), (k)(6) (2012 & Supp. 2018).

50. *Id.* § 168(k)(6). The legislation permanently increased the amount of capital investments that may be expensed under a different, albeit limited, provision. The amount that may be expensed under this provision has been increased from $500,000 to $1,000,000, and the limit pursuant to which this benefit phases-out has been increased. *See id.* § 179(b).

of their qualified business income.[51] The deduction is an itemized deduction but not subject to any limitation on such deductions.[52] Moreover, the deduction is available only for income tax purposes.[53] The amount of the deduction is 20% of the qualified business income with respect to a qualified trade or business limited to the greater of 50% of wages paid with respect to such trade or business or, if greater, the sum of 25% of such wages and 2.5% of the unadjusted basis of qualified property employed in such trade or business.[54] A qualified trade or business is any trade or business except the performance of services as an employee, and trades or businesses that provide "services in the fields of health, law, . . . accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services," any business whose principal asset is the skill and reputation of one or more employees or owners, and investment management and securities and commodities dealers and traders.[55]

The limitation based on wages or wages plus assets is a crude method of linking the deduction to income that the employment of human and physical capital generates. But these limitations do not apply to single taxpayers whose taxable income does not exceed $157,500 or to married taxpayers filing a joint return whose taxable income does

51. I.R.C. § 199A(a), (i) (2018).

52. I.R.C. §§ 62(a), 63(b)(3) (2012 & Supp. 2018).

53. I.R.C. § 199A(f)(3) (2018).

54. *Id.* § 199A(a)(1)(A), (b)(1)(A), (b)(2). Wages include, for this purpose, certain elective deferrals such as § 401(k) deferrals and employer matching contributions. *See id.* § 199A(b)(4), I.R.C. § 6051(a)(8) (2012 & Supp. 2017). Qualified property, for this purpose, is depreciable property used in the qualified trade or business. I.R.C. § 199A(b)(6) (2018). In addition, 20% of qualified dividends from real estate investment trusts, qualified publicly traded partnership income, and qualified cooperative dividends are deductible. *Id.* § 199A(a)(2), (b)(1)(B). The deduction is subject to an overall limit of 20% of taxable income, and, for this purpose, taxable income is determined exclusive of capital gains, cooperative dividends, and this deduction. *Id.* § 199A(a)(1)(B), (e)(1).

55. I.R.C. §§ 199A(d)(1)(A), (d)(2)(A)–(B), 1202(e)(3)(A) (2012 & Supp. 2018). Recently issued proposed regulations limit the definition of a business whose principal asset is the skill and reputation of one or more employees or owners to a business that generates its income from endorsements, licensing, appearances, and similar fees. *See* Prop. Treas. Reg. § 1.199A-5(b)(2)(xiv), 83 Fed. Reg. 40884, 40899 (Aug. 16, 2018). The proposed rules also contain some helpful de minimis rules that apply to businesses that generate incidental service income. *See id.* § 1.199A-5(c)(3), at 40925–27.

not exceed $315,000.[56] The deduction limitations are phased in for taxpayers whose taxable income exceeds the aforementioned thresholds by no more than $50,000 and $100,000 for single and married taxpayers, respectively.[57] For example, assume that a married taxpayer filing a joint return had taxable income, for purposes of § 199A, of $365,000 and that the deduction under this section is $30,000 without regard to the wage or wage and asset limitations. Assume that the application of the limitations would reduce the deduction by $10,000. Because the taxpayer's income exceeds the threshold by $50,000, the reduction caused by the wage or wage and asset limitation is phased in. The taxpayer's taxable income exceeds the threshold by $50,000, one-half of the $100,000 phase-out range applicable to married taxpayers filing a joint return. Thus, one-half, or $5,000, of the reduction caused by the limitations is applied, thereby reducing the taxpayer's deduction from $30,000 to $25,000.

As noted above, certain service businesses are not qualified trades or businesses for this purpose.[58] Yet special rules are provided for these trades or businesses. For taxpayers who are engaged in such service businesses and whose taxable income does not exceed the thresholds described above, the deduction provided by this section is allowed without regard to any wage or wage and asset limitation.[59] Qualified business income, wages, and the unadjusted basis of property limitations are reduced proportionately for taxpayers whose taxable income exceeds the aforementioned thresholds by no more than $50,000 and $100,000 for single and married taxpayers, respectively.[60]

---

56. I.R.C. § 199A(b)(3)(A), (e)(2)(A) (2018). These amounts are adjusted in subsequent years for inflation. *Id.* § 199A(e)(2)(B). Taxable income for this purpose is determined without regard to this deduction. *Id.* § 199A(e)(1).

57. *Id.* § 199A(b)(3)(B).

58. *See supra* note 55 and accompanying text. Proposed regulations issued in August 2018 contain several anti-abuse rules designed to prevent taxpayers from avoiding the application of these rules. For example, the proposed regulations prevent taxpayers, in most cases, from separating the administrative and staff functions of a professional service firm into a separate entity that would not be classified as a specified service business. The proposed regulations would also prevent the use of multiple trusts if the purpose is to allow such trusts to avoid the income-based phase-out rules applicable to service businesses. *See* Prop. Treas. Reg. §§ 1.199A-5(d)(3), 1.199A-6(d)(3)(v), 83 Fed. Reg. 40884, 40927-29 (Aug. 16, 2018).

59. I.R.C. § 199A(d)(3) (2018).

60. *Id.*

For example, assume that a single attorney has taxable income of $150,000, all of which is income generated by her sole proprietorship law practice. The attorney employs an administrative assistant to whom she paid $50,000 in wages, and the unadjusted basis of depreciable assets employed in the practice total $40,000. Because her income is below the threshold for single taxpayers, her trade or business of the practice of law is a qualified trade or business, and she is not subject to any wage or wage and asset limitation. Therefore, she is entitled to a deduction of $30,000, 20% of her qualified business income. If her taxable income was $300,000, then she would be entitled to no deduction because the law practice would not be considered a qualified trade or business. If, however, her taxable income was $182,500, then she would exceed the threshold amount by $25,000, one-half of the $50,000 phase-out range applicable to single individuals.

In the case of partners or shareholders of S corporations, these provisions are applied at the partner or shareholder level.[61] Wages of the entity allocable to a partner or shareholder are "determined in the same manner" as such person's share of the entity's wage expenses.[62] The unadjusted basis of the entity's property allocable to a partner or shareholder is determined in the same manner as such person's share of the entity's depreciation expense.[63]

A significant element of uncertainty exists with respect to this provision's application to taxpayers who perform services in a qualified trade or business. As previously noted, the trade or business of the performance of employment services is not a qualified trade or business.[64] Therefore, no deduction is available under this provision for income received by an S corporation shareholder as employee compensation. But the statute excludes from qualified business income "reasonable compensation paid to the taxpayer by any qualified trade or business . . . for services rendered," guaranteed payments to partners for services rendered, and to the extent provided in regulations, other payments for services to partners deemed received by such partner in

---

61. *Id.* § 199A(f)(1)(A)(i).
62. *Id.* § 199A(f)(1)(A)(iii).
63. *Id.*
64. *See supra* note 55 and accompanying text.

a non-partner capacity.[65] Guaranteed payments to partners are those payments made without regard to partnership income.[66] Consequently, this exclusion is avoidable with relative ease if it is economical and desirable to do so.[67] For example, a partner may receive a preferred, or priority, return instead of a guaranteed return. It is not clear how the I.R.S. will interpret the exclusion for payments to partners for services rendered to the partnership in a non-partner capacity.

More problematic is the exclusion for reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered.[68] A broad interpretation of this exclusion could result in a portion of self-employment income, partnership income, or S corporation income to be ineligible for the deduction. S corporation shareholders have long had incentives to minimize salaries paid to shareholder-employees for payroll tax purposes, and this has led to numerous fact intensive disputes with the I.R.S. regarding the reasonableness of such salaries.[69] The deduction for qualified business income provides another reason for S corporation shareholders to minimize their salaries and may embolden the I.R.S. to more aggressively challenge the reasonableness of such compensation.[70] Those same disputes very well could become commonplace in the partnership and self-employment setting. For example, it is conceivable that all the income of a self-employed consultant with no employees could be considered for services rendered by the consultant. After all, the consultant's personal efforts generated the income. Similarly, a portion of the income derived by a partner who actively participates in the business could be

---

65. I.R.C. § 199A(c)(4) (2018).

66. I.R.C. § 707(c) (2012).

67. In certain circumstances a partner who provides a disproportionate share of services to a partnership in comparison to her fellow partners may demand a guaranteed payment for such services.

68. *See supra* note 65 and accompanying text.

69. *See infra* note 169 and accompanying text.

70. The amount of payroll taxes at issue generally is not significant for any salaries that exceed the wage base for old-age, survivor, and disability insurance because the tax rate applicable to wages more than this base is relatively low. *See infra* note 169 and accompanying text. Recently issued proposed regulations do not address the issue of unreasonably low compensation. The proposed regulations also did not address preferred returns or offer additional guidance with respect to payments to partners for services rendered in a non-partner capacity. *See* Prop. Treas. Reg. §§ 1.199A-0 to 1.199A-6, 83 Fed. Reg. 40884, 40909–29 (Aug. 16, 2018).

reclassified as compensation for services. If this provision does, in fact, serve as a mechanism for the reclassification of income, then the method by which such a reclassification occurs should be—and hopefully will be—administratively practical. Some sort of safe harbor methodology would be welcome to avoid the uncertainty of, and the inevitable disputes over, the application of a facts and circumstances determination.

The full 20% deduction will reduce the effective highest marginal income tax rate for income earned by sole proprietors and owners of pass-through entities from 37% to 29.6%.[71] The deduction does not apply to payroll taxes or the Unearned Income Medicare Contribution, so the deduction does not mitigate the effect of these taxes.[72] The greatest disparity between corporate and individual income tax rates will arise in situations in which the entity's owners do not qualify for the deduction for pass-through income, due to either the nature of the business or the application of the limitations on the deduction;[73] the income is subject to the Unearned Income Medicare Contribution;[74] and the earnings are likely to be retained in the business. In such circumstances, the individual faces a marginal tax rate of 40.8%,[75] a 19.8 percentage point difference from the 21% corporate tax rate that would apply to the earnings retained in the business. Businesses whose owners intend to distribute most, if not all, earnings are the least desirable candidates for incorporation. In such cases, any distributions in the

71. This figure is determined as follows: .37 - (.2 x .37)).

72. It is not clear whether the deduction for one-half of self-employment taxes reduces the amount of trade or business income that is subject to the deduction for pass-through earnings, although it likely will. If so, the effect on the deduction will be minimal due to the earnings cap on the old-age, survivors, and disability portion of that tax. *See supra* note 27 and accompanying text.

73. *See supra* notes 54–55 and accompanying text.

74. *See supra* note 26 and accompanying text. Note that the income could be subject to the self-employment tax. For taxpayers who have already exceeded the earnings base for the old-age, survivors, and disability insurance portion of the self-employment tax, the self-employment tax will, at most, be 3.8%, and because a portion of this is deductible for income tax purposes, its net effect is less than the Unearned Income Medicare Contribution. *See supra* note 27 and accompanying text; *infra* notes 170–72 and accompanying text.

75. This figure represents the sum of the 37% marginal income tax rate and the 3.8% Unearned Income Medicare Contribution. *See supra* note 27 and accompanying text.

form of salaries, rents, and similar deductible expenses at the corporate level would be taxed at the individual's effective marginal tax rate and any dividends would be taxable at an effective rate as high as 39.8%.[76] The benefit to a particular taxpayer will depend on numerous factors, including the extent to which the deduction for pass-through earnings is available; the application of payroll taxes, self-employment taxes, and the Unearned Income Medicare Contribution; and—perhaps most importantly—the extent of earnings retention that is both possible and desirable.

Any tax benefit derived by the retention of earnings by the corporation will compound over the years because the return on those earnings will be taxed more favorably at the corporate level than at the individual level. The accretion of earnings in the corporation will manifest itself in an increase in the stock value, and this increase in value could escape any income taxation at the individual level if the stock is held by its owner until death—a benefit that the new legislation made easier to obtain.[77] This benefit is not without its costs, however. The retention of corporate earnings should not be driven solely by tax considerations. Distribution of corporate earnings permits shareholders to diversify their wealth, and this consideration should not be ignored. Moreover, although the increase in the corporate stock's value will escape income taxation upon the death of the shareholder, the corporate assets' tax basis will not be adjusted. The death of a partner, on the other hand, permits the partnership to adjust the tax basis of partnership

---

76. *See supra* note 30 and accompanying text.

77. In general, the tax basis of assets acquired from a decedent is their fair market value at the time of death. *See* I.R.C. § 1014(a)(1) (2012 & Supp. 2015). The Tax Cuts and Jobs Act doubled the amount of assets that an individual may transfer during life and at death without the incurrence of gift or estate taxes effective after 2017 and before 2026. *See* I.R.C. § 2010(c)(3)(C) (2012 & Supp. 2017). This increase will reduce the impetus for many taxpayers to make lifetime gifts to minimize estate taxes. Despite the existence of a gift tax that compliments the estate tax, gifts are often used to rid an estate of assets that are projected to increase in value. The tax basis of assets to a gift donee is, in most circumstances, the same tax basis that the assets had in the donor's hands. *See* I.R.C. § 1015 (2012). The doubling of the estate tax exclusion amount reduces the need for many taxpayers to make *inter vivos* transfers.

assets for the benefit of the partner succeeding to the decedent's interest.[78] As noted previously, there are limits on the extent to which earnings can be retained in the corporation without unfavorable tax consequences but, if care is taken, significant tax benefits can be realized.[79]

Assumptions and generalizations are no substitute for detailed analysis based on the peculiarities of the individuals and businesses in question. Moreover, the effect of income taxes on future income must be complimented by two other tax-related considerations. First, the immediate tax consequences of the conversion to a corporate form must be determined, and these consequences may vary considerably depending upon whether the business is currently operated as a partnership or S corporation. Second, it is generally advisable not to assume that the status quo has a long shelf life. Taxpayers should not ignore the possibility that, soon, the corporate form will become undesirable. A return to the status quo ante may come with a tax cost or, perhaps, be unfeasible.

III. Conversion to a C Corporation

The decision to convert to C corporation status should not be based solely on the tax rate effects of such a conversion. Other factors should be considered, including whether an entity's owners have suspended losses allocable to the entity,[80] and for non-corporate entities,

78. *See* I.R.C. § 743(b) (2012 & Supp. 2017). A similar adjustment is available to the purchaser of a partnership interest. *See infra* note 158 and accompanying text. There is no statutory provision that permits similar adjustments to the tax basis of corporate assets because of a shareholder's death. Consequently, this consideration is inapplicable to the holders of S corporation stock that are contemplating the conversion of their corporation to C corporation status.

79. *See supra* note 24 and accompanying text.

80. There are several limitations on the ability to deduct losses from an activity, most notably the basis limitation rules and the passive activity loss rules. A partner may deduct losses from a partnership only to the extent of her tax basis in the partnership. Any losses more than basis are carried forward until the taxpayer has obtained sufficient basis to utilize the losses. *See* I.R.C. § 1366(d) (2012 & Supp. 2018). Upon incorporation, the partner would no longer own the partnership interest and, therefore, would be unable to utilize suspended losses. *See* I.R.C. § 704(d) (2012 & Supp. 2017). An S corporation shareholder may utilize losses to the extent of her tax basis in the stock of the corporation plus any basis in debt that the corporation owes her. In general, the termination of an S corporation election will result in the similar permanent loss of suspended losses due to the basis limitation rules. However,

whether operational idiosyncrasies can be feasibly maintained in a corporate tax structure.[81] Moreover, the conversion itself will have immediate tax consequences whose magnitude and effects will vary considerably depending on the particular facts and circumstances of the entity seeking to convert its tax status.

A. S Corporation to C Corporation

Conversion of an existing S corporation to a C corporation is straightforward—the corporation simply revokes its S corporation election.[82] If an S election is revoked, then the corporation is precluded

---

suspended losses that the taxpayer incurred in the S corporation's final year may be available for use to a very limited extent during a brief statutory post-termination period. *See* I.R.C. § 1377(b) (2012); Treas. Reg. § 1.1366-2(b)(1) (2014). The passive loss rules limit the ability of a taxpayer to deduct losses from passive activities, and these rules limit such losses to income from passive activities. *See* I.R.C. § 469 (2012 & Supp. 2018). If suspended passive losses are allocable to an activity that is now housed in a C corporation, the suspended losses retain their character in the hands of the individual taxpayer who incurred such losses. However, dividends received from the corporation are not considered passive income. *See* Treas. Reg. § 1.469-1(f)(4)(ii) ex. 5 (2002). A detailed discussion of the passive activity loss rules is beyond the scope of this work. In any event, it is unlikely, though conceivable, that an entity contemplating a conversion to C corporation status would have generated suspended losses because the impetus for such conversions is to obtain the benefit of the lower corporate tax rate and, therefore, such conversions would be attractive to profitable enterprises. The new legislation added a new loss limitation for non-corporate taxpayers applicable to excess business losses that survive the application of the passive loss rules. In general, losses from trades or businesses of more than $250,000 are disallowed and treated as a net operating loss carryover to the succeeding year. This loss limitation is effective for taxable years beginning after 2017 and before 2026. *See* I.R.C. § 461(l) (2012 & Supp. 2018); *see also* I.R.C. § 465(a)(1) (2012 & Supp. 2017) (limiting losses to the amount that a taxpayer has at risk).

81. Disproportionate distributions among owners may prove difficult to maintain in a corporate structure. *See infra* note 118 and accompanying text.

82. I.R.C. § 1362(d)(1)(A) (2012 & Supp. 2018). Shareholders holding more than 50% of the corporation's shares of stock must consent to the revocation. *Id.* § 1362(d)(1)(B). The revocation may specify the date on which the revocation is effective provided that such date is on or after the date on which such revocation is made. *Id.* § 1362(d)(1)(C). If no effective date of the revocation is specified, then a revocation made on or before the 15th day of the third month of the taxable year is effective on the first day of the taxable year, and a revocation made after the 15th day of the third month of the taxable year is effective on the first day of the following taxable year. *Id.* § 1362(d)(1)(D). The revocation of the election could require a

from electing S corporation status before its fifth taxable year that begins after the first taxable year for which the revocation is effective, unless the I.R.S. consents.[83] Certain favorable transition rules apply during the post-termination transition period and, for eligible terminated corporations, after such period with respect to distributions made to shareholders. Absent an election to the contrary, distributions made during this period will not be considered dividends to the extent of earnings accumulated during the period that the corporation was an S corporation, and for eligible terminated corporations, distributions after such period will be considered dividends on a pro-rated basis.[84] In general, the post-termination transition period is the period beginning on the last day of the corporation's taxable year as an S corporation and ending on the later of one year after such date or the due date for filing the income tax return for the last year of the corporation's S corporation status.[85] As previously discussed, the revocation of an S corporation election could preclude the ability of shareholders to utilize losses from previous years that have been suspended under various rules.[86]

---

corporation that used the cash method of accounting to change to the accrual method of accounting. With certain exceptions, C corporations are not eligible to use the cash method accounting. *See generally* I.R.C. § 448 (2012 & Supp. 2017). *See also supra* note 43 (describing a change made by the Tax Cuts and Jobs Act to § 448). Any adjustment requiring such change in accounting method is recognized over a six-year period beginning with the year of change. *See* I.R.C. § 481(d)(1) (2012 & Supp. 2017).

83. I.R.C. § 1362(g) (2012 & Supp. 2018).

84. I.R.C. § 1371(e)–(f) (2012 & Supp. 2017). The Tax Cuts and Jobs Act added the latter provision. An eligible terminated S corporation is any C corporation that is an S corporation on the day before the date of enactment of the Tax Cuts and Jobs Act that revokes its S corporation election during the two-year period beginning on the date of enactment, all the owners on the date that the election is revoked are the same owners, and in identical proportions, as the owners on the date of enactment. In the case of a distribution of money by an eligible terminated S corporation, distributions are allocated among earnings accumulated by the corporation as an S corporation and the C corporation's accumulated earnings and profits proportionately.

85. I.R.C. § 1377(b)(1)(A) (2012). Special rules apply in the case of certain audit adjustments and determinations by the I.R.S. that an S election had terminated in a previous year. *See id.* § 1377(b)(1)(B)–(C).

86. *See supra* note 80 and accompanying text.

B. Conversion of Partnership to C Corporation

Absent an election to be taxed as a corporation, a domestic business entity that is not incorporated under a federal or state statute is classified, for federal income tax purposes, as a partnership if it has two or more members or is disregarded if such entity has a single owner.[87] Taxpayers who wish to change their entity's classification can do so in several ways. The simplest method is to elect a classification change without disturbing the form of organization under state law. A non-corporate entity can elect to be classified initially as a corporation for federal income tax purposes or can elect to subsequently change its classification to a corporation at a later time.[88] An election to change classification cannot be altered during the sixty-month period succeeding the election.[89] An entity that changes its classification from a partnership to a corporation is deemed to have contributed all

---

87. Treas. Reg. §§ 301.7701-2(b)(1) (2016); 301.7701-3(b)(1)(i)–(ii) (2006). A disregarded entity is not disregarded for employment tax purposes and certain other purposes. *See* Treas. Reg. § 301.7701-2(c)(2)(i)–(v) (2016). For decades, the classification of an entity as a corporation or a partnership for tax purposes was determined by the examination of certain attributes of the entity in question. *See generally* Morrissey v. Comm'r, 296 U.S. 344, 359–60 (1935); United States v. Kintner, 216 F.2d 418, 421–24 (9th Cir. 1954); Treas. Reg. § 301.7701-1(b) (2011). The emergence of LLCs during the 1990s magnified the importance of entity classification because the LLC form provided taxpayers with an extremely flexible non-corporate vehicle with which to limit the personal liability exposure of the entity's owners. Current Treasury regulations discard the previous entity classification rules in favor of a system under which non-corporate entities elect whether they are taxed as corporations, or as the case may be, partnerships, or disregarded. Less than a decade ago, the Sixth and Second Circuits upheld these so-called check-the-box regulations. *See* McNamee v. Dep't of the Treasury, 488 F.3d 100, 109 (2d Cir. 2007); Littriello v. United States, 484 F.3d 372, 378 (6th Cir. 2007), *cert. denied*, 552 U.S. 1186 (2008).

88. Treas. Reg. § 301.7701-3(a) (2006). Such elections are made by filing Form 8832 with the I.R.S. *Id.* § 301.7701-3(c)(i). The election is effective on the date specified on the form so long as the date specified is no more than seventy-five days prior to, or twelve months later than, the date on which the election is filed. *Id.* § 301.7701-3(c)(iii). If the form does not specify a date, then the election is effective on the date it is filed. *Id.*

89. *Id.* § 301.7701-3(c)(iv). The I.R.S. may approve a change in classification during the sixty-month period if there is change in more than 50% of the ownership of the entity during this period. *Id.*

its assets and liabilities to the corporation in exchange for the corporation's stock, which is then deemed distributed to its partners in liquidation of the partnership.[90]

Alternatively, the entity can convert its status under a state conversion statute, if applicable. State conversion statutes provide an efficient mechanism for converting an entity from one form to another. Such statutes require filing a plan of conversion and certain forms with the appropriate state officials, and avoid the costs and administrative inconvenience of liquidating the existing entity and recontributing assets to a new entity or merging the existing entity into a new entity.[91] Typically, the new entity is deemed a continuation of the old entity without interruption; all assets and liabilities of the old entity become assets and liabilities of the new entity; and all the rights, privileges, immunities, and powers of the converted entity are vested without change in the converted entity.[92] A conversion of an entity taxed as a partnership to a corporation under a state conversion statute has the same tax consequences as an election to change classification.[93] Therefore, the entity is deemed to contribute its assets to the corporation in exchange for stock and then is deemed to have distributed the stock to its owners in complete liquidation.[94]

In most cases, it would be most efficient to change classification by election because the election would have no effect on the form of business under state law. This avoids any need to draft new governing documents.[95] If, for some reason, corporate status under state law is

---

90. *Id.* § 301.7701-3(g)(1)(i). The election by a heretofore disregarded entity is treated as a contribution of all the entity's assets and liabilities to the corporation by the owner of the entity in exchange for the corporation's stock. *Id.* § 301.7701-3(g)(1)(iv). Conversely, an election to classify an entity that was previously taxed as a corporation as a partnership is deemed a liquidation of the corporation and a contribution by the shareholders of such assets and liabilities to the partnership. *Id.* § 301.7701-3(g)(1)(ii).

91. *See, e.g.*, 15 PA. CONS. STAT. § 352 (2014).

92. *See, e.g.*, *id.* § 356.

93. *See* Rev. Rul. 2004-59, 2004-1 C.B. 1050.

94. *See supra* note 90 and accompanying text.

95. The entity's reclassification to a C corporation may require amendments to various agreements because the entity will now be a taxpaying entity. For example, loan covenants may refer to net income, and compensation agreements may provide bonuses determined on some metric that references net income. These agreements

desirable, then use of a state law conversion statute would, in most cases, make sense.[96] For existing partnerships and LLCs, reclassification could result in a change in the basis of assets to the owners and, in some cases, immediate gain recognition. The deemed contribution of assets by the partnership to the corporation will be governed by § 351, which provides that no gain or loss is recognized if property is transferred to a corporation solely in exchange for stock of such corporation if immediately after the exchange, the transferee or transferees are in control of such corporation.[97] Gain, but not loss, is recognized to the extent that the transferee received money or other property.[98] The assumption of liabilities is not considered the receipt of money or other property unless the amount of liabilities assumed exceeds the tax basis of the properties transferred in the exchange.[99] The corporation recognizes no gain or loss on the transaction, and the tax basis of the assets to the corporation is the tax basis of the assets in the partnership increased by any gain recognized by the partnership in the exchange.[100]

---

should be examined to determine if their provisions will be affected by the change in the tax status of the corporation.

96. For example, state tax laws may encourage the use of a corporate entity to achieve the owners' tax objectives. In addition, if the corporate form offers greater liability protection to the owners, then it may be desirable to incorporate.

97. I.R.C. § 351(a) (2012). Control is defined as ownership of 80% of the combined voting power of all classes of stock and 80% of all other classes of stock. *Id.* § 368(c) (2012 & Supp. 2018). Certain exceptions apply for stock issued for services and certain indebtedness, transfers to investment companies, and transfers for certain forms of preferred stock. *See* I.R.C. § 351(d), (e), (g) (2012).

98. I.R.C. § 351(b) (2012).

99. *Id.* § 357(a), (c)(1). Liabilities assumed and whose payment would give rise to a tax deduction are excluded for this purpose. *Id.* § 357(c)(2). If the principal purpose of the assumption of liabilities is to avoid federal income tax or such assumption does not have a bona fide business purpose, then all liabilities assumed are considered to be money received in the exchange and, hence, taxable. *Id.* § 357(b).

100. I.R.C. § 362(a) (2012 & Supp. 2018), I.R.C. § 1032 (2012). Special rules exist that prevent the tax basis of property from exceeding its fair market value as a result of gain recognition by the transferee, and certain basis limitations are placed on assets that, in the aggregate, have built-in losses. *See* I.R.C. § 362(d)–(e) (2012 & Supp. 2018). The corporation's holding period for the property received will include the transferee's holding period. *See id.* § 1223(2). Depreciable property that is transferred to a corporation is depreciated under the same depreciation method and recovery period used by the transferor to the extent that the corporation's basis in the property is the same as the transferor's basis in the property. *Id.* § 168(i)(7). If the

The partnership's tax basis in the stock it is deemed to have received is equal to the tax basis of the property transferred less money, the fair market value of other property received, and any loss recognized by it, and increased by any gain it recognized on the exchange.[101] The partnership recognizes no gain or loss on its deemed liquidation.[102] The partners recognize no gain on the liquidation except to the extent that they receive money in excess of their adjusted tax basis in their partnership interest.[103] The partners' tax basis in the shares they receive will be the tax basis of their partnership interests less any money they receive in the transaction.[104]

Two advantages of the partnership form could result in the recognition of gain by either the partnership or the partners because of a change in classification. Unlike corporations, a partner's tax basis in

---

corporation's basis in the property exceeds the transferor's basis, then the corporation depreciates the excess basis as newly purchased depreciable property and uses the recovery period and depreciation method applicable to the class of property transferred. Prop. Treas. Reg. § 1.168-5(b)(7), 49 Fed. Reg. 5940, 5965–66 (Feb. 16, 1984). It is unclear how depreciation is determined if the corporation's basis in the property is less than the transferor's basis. Proposed rules have been issued for property whose basis has been re-determined and these rules would be applicable, but they were issued over three decades ago and do not reflect numerous changes in the law since their issuance. *See id.* § 1.168-2(d)(3), at 5946; *id.* § 1.168-5(b)(6), at 5964. For certain older entities, any increase in the basis of certain intangible assets would not be amortizable. Section 197 permits certain intangible assets to be amortized over a fifteen-year period. An otherwise amortizable intangible asset is not amortizable if it was not amortizable under prior law and was held or used at any time on or after July 25, 1991, and on or before August 10, 1993, by the taxpayer or a related party; was acquired from a person who held the intangible during the aforementioned period and, as part of the transaction, the user of the intangible does not change; or the taxpayer grants the right to use the intangible to a person, or a person related to such person, who held or used the intangible during that period. I.R.C. § 197(f)(9)(A)(i)–(iii) (2012).

101. I.R.C. § 358(a) (2012).

102. *Id.* § 731(b).

103. *Id.* § 731(a)(1). Marketable securities are considered money for this purpose. *See id.* § 731(c).

104. *Id.* § 732(b). The holding period for which a taxpayer has held the stock deemed received will include the holding period of the property transferred. *See* I.R.C. § 1223(1) (2012 & Supp. 2018).

the partnership includes such partner's share of partnership debts.[105] An increase or decrease in a partner's share of partnership liabilities is treated as a contribution of money to or a distribution of money from the partnership, respectively.[106] Moreover, in contrast to S corporations, partnership income can be allocated to the partners in any way

---

105. A partner's tax basis in the partnership establishes the amount of losses that may be utilized by the partner and the amount of distributions that will be untaxed to the partner. *See* I.R.C. § 704(d) (2012 & Supp. 2018); I.R.C. § 731(a) (2012).

106. I.R.C. § 752(a)–(b) (2012). The regulations governing the determination of a partner's share of partnership debt are complex, and a detailed analysis of the regulations are beyond the scope of this work. In general, a partner's share of partnership recourse debt, defined as a debt to the extent that any partner bears the economic risk of loss, is the amount for which the partner, or a person related to such partner, bears the economic risk of loss. This amount is equal to the amount that a partner or related person would be obligated to pay to any person if the partnership liquidated, its assets were worthless, and all liabilities of the partnership were payable in full. *See* Treas. Reg. § 1.752-1(a)(1) (2005); Treas. Reg. § 1.752-2(a)–(b) (2016). A partner's share of partnership nonrecourse debt, defined as a debt for which no partner bears the economic risk of loss, is the sum of the partner's share of partnership minimum gain; the amount of gain that would be allocated to the partner under section 704(c) of the Internal Revenue Code principles if the assets encumbered by the nonrecourse debt were disposed of for no consideration other than satisfaction of the nonrecourse debt; and the partner's share, based in the partner's share of profits, of any remaining nonrecourse debt. Treas. Reg. § 1.752-1(a)(2) (2005); Treas. Reg. § 1.752-3(a) (2016). Partnership minimum gain exists in circumstances in which nonrecourse debt exceeds the book value of the property for capital account purposes. See *infra* note 107 for a discussion of capital accounts.

With respect to the second prong of nonrecourse debt, the § 704(c) allocation, three methods are available for determining § 704(c) allocations. Under the traditional method, tax allocations of cost recovery deductions to noncontributing partners must, to the extent possible, equal book allocations to those partners. *See* Treas. Reg. § 1.704-3(b)(1) (2017). However, those allocations are limited to the total tax deductions with respect to the property—the ceiling rule. *Id.* A second method combines the traditional method with curative allocations that are designed to reduce, in whole or in part, the effect of the ceiling rule. *See id.* § 1.704-3(c)(1). In effect, existing deductions are allocated to mitigate the effect of the ceiling rule. Finally, taxpayers may elect to employ a third method, the remedial method, which approximates the effect of the second method, albeit with certain crucial distinctions. Remedial allocations correct the effect of the ceiling rule through the creation of notional tax deductions. Unlike curative allocations, remedial allocations must fully offset the ceiling rule—no partial offsets are permitted. *See id.* § 1.704-3(d)(1). Because the remedial method is the only method that assures the inapplicability of the ceiling rule,

the partners choose provided that the method chosen has substantial economic effect.[107] It is possible, therefore, for a highly leveraged

---

the I.R.S. has issued guidance that this second prong is applicable only if the partnership uses the remedial method of allocation. *See* Rev. Rul. 95-41, 1995-1 C.B 132.

107. The ability to allocate partnership items among the partners according to the partnership agreement made it possible for partnerships to divorce the allocation of tax items from the economic realities of the partners' arrangements. As a result, § 704(b) requires that allocations pursuant to the partnership agreement have substantial economic effect. Otherwise, tax items will be allocated pursuant to the partners' interests in the partnership—a vague standard whose application is fact intensive. Regulations created a safe harbor for determining whether partnership allocations have economic effect. To satisfy the safe harbor, partnerships must comply with an elaborate set of rules for the maintenance of capital accounts, adjustments to which must have economic consequences. Whether such economic effect is substantial is a separate issue that focuses on whether such allocations merely shift tax consequences among the partners or result in transitory consequences. *See* Treas. Reg. § 1.704-1(b)(2)(iii) (2017).

In general, capital accounts must be maintained that reflect contributions, distributions, and allocations of income, gain, deductions, and losses. *Id.* § 1.704-1(b)(2)(iv). Capital accounts are increased by the fair market value of property contributed and decreased by the fair market value of property distributed. *See id.* § 1.704-1(b)(2)(iv)(b). In certain circumstances, the partnership may revalue partnership property to fair market value. *See id.* § 1.704-1(b)(2)(iv)(f). Liquidation of the partnership must be in accordance with the capital accounts, and partners must have an obligation to restore deficits in their capital accounts. *Id.* § 1.704-1(b)(2)(ii)(b)(2)–(3). The failure to provide for a deficit restoration is not fatal if the partnership can meet an alternative test through the provision of a qualified income offset. *See id.* § 1.704-1(b)(2)(ii)(d). Special rules are provided for allocations attributable to partnership nonrecourse debt. Because of the nonrecourse nature of such debt, the deficit restoration provision cannot be met with respect to deductions attributable to such debt. For allocations of deductions attributable to nonrecourse debt to have economic effect, the partnership agreement must provide for a minimum gain chargeback. In effect, the regulations force losses attributable to such debt to be charged back to the partners to whom they were allocated. *See generally* Treas. Reg. § 1.704-2 (2016). These regulations have been subject to criticism due to their complexity and to doubts about their effectiveness. *See generally* Simon Friedman, *Partnership Capital Accounts and Their Discontents*, 2 N.Y.U. J.L. & BUS. 791 (2006). Partnership agreements often contain allocation provisions that result in capital account balances that reflect what the partners would receive upon liquidation. *Id.* at 792. Under such provisions, the capital account balances do not determine liquidation entitlements. Instead, the partners' agreement with respect to liquidation determines capital accounts. *See id.* (terming such provisions as "targeting" or "tracking" allocations). Reliance on liquidation value tends to ignore the time value of money. For example, a partner may be willing to absorb a loss in her capital account that would ensue from

partnership to recognize a gain on the deemed contribution by it to the corporation or for partners who have received a disproportionate share of distributions, losses, or both over the years to face unpleasant consequences.

EXAMPLE: LLC is a three-member LLC treated as a partnership for federal income tax purposes. The company's operating agreement allocates income, deductions, gains, losses, credits, and distributions equally among the three members. When the three members formed the company in 2001, they contributed an equal amount of cash in exchange for their membership interests. The company has been very profitable over the years and has distributed most of its cash flow annually. In 2012, the company took on debt secured by appreciated property and used the cash to fund distributions to its members. As a result, the company's 2017 year-end balance sheet reflected assets with a tax basis of $9 million, debt of $15 million, and a deficit in members' equity of $6 million. Each member had a tax basis in her membership interests of $3 million, which represented each member's $2 million equity deficit plus each member's $5 million share of the LLC's debt.[108] The LLC elects, pursuant to Treasury Regulation § 301.7701-3(a), to reclassify its tax status to a corporation effective January 1, 2018.

The LLC is deemed to have contributed its assets and liabilities to a corporation in exchange for its stock.[109] Pursuant to §§ 351 and 357(c), this deemed transaction results in the recognition of gain to the LLC of $6 million, the excess of liabilities over the tax basis of the assets.[110] The LLC has a tax basis in the stock it is deemed to have

---

a disproportionate allocation of tax deductions despite the concomitant reduction in the amount to which she would be entitled upon liquidation if liquidation was not imminent and that future operating results likely would restore her capital account. Moreover, pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) (2017), revaluations of capital accounts are not routinely performed because such revaluations are permitted only upon the happening of certain events and, therefore, capital account balances do not necessarily reflect economic reality. *Id.*

108. *See* I.R.C. § 752(a)–(b) (2012); Treas. Reg. § 1.752-1(a)(1)–(2) (2005); Treas. Reg. § 1.752-2(a)–(b), 1.752-3(a) (2016); Treas. Reg. § 1.704-3(b)(1), (c)(1) (2017); Rev. Rul. 95-41, 1995-1 C.B. 132.

109. *See* Treas. Reg. § 301.7701-3(g)(1)(i)–(ii), (iv) (2006).

110. *See* I.R.C. § 351(a)–(b), (d)–(e), (g), 357(a)–(b), (c)(1)–(2) (2012); I.R.C. § 368(c) (2012 & Supp. 2018). The regulations provide that the relative fair market

received of $0, which is the $9 million tax basis of the assets transferred to the corporation less the $15 million of liabilities transferred plus the $6 million gain it recognized.[111] The members' tax basis in the LLC is increased by $2 million, their share of the $6 million gain recognized by the LLC, and reduced by their reduction in their share in the $15 million reduction in LLC's liabilities, $5 million.[112] Consequently, the members' tax basis in the LLC is $0. Upon receipt of the stock in liquidation of the LLC, the members obtain a tax basis of $0 in the newly converted entity's stock.[113] The corporation has a tax basis in the assets it receives of $15 million, which represents the tax basis of the assets in the hands of the LLC plus the $6 million gain recognized by the LLC.[114] The net result is the elimination of each member's equity deficit, the recognition of $2 million of taxable gain by each member, and a $6 million increase in the tax basis of the assets inside the entity.[115]

EXAMPLE: Assume the same facts set forth in the previous example except that the LLC's balance sheet at the end of 2017, on a tax basis, reflects assets of $18 million and debt of $15 million. The operating agreement, however, contained a host of special income and

---

value of the assets transferred determines the character of the gain recognized. Therefore, if 30% of the assets are not capital assets, then 30% of the gain is ordinary income. *See* Treas. Reg. § 1.357-2(b) (1980). These regulations have been criticized, and it is not entirely free from doubt whether the character of the gain should be based solely on the character of assets that have appreciated in value rather than on the character of all assets. *See generally* Fred B. Brown, *Determining the Character of Section 357(c) Gain*, 62 TAX LAW. 117 (2008).

111. *See* I.R.C. § 358(a) (2012).

112. *See generally* I.R.C. § 704(d) (2012 & Supp. 2017); I.R.C. §§ 705(a), 722–23, 731, 752 (2012); I.R.C. § 1366(d) (2012 & Supp. 2018); Treas. Reg. § 1.752-1(a)(1)–(2) (2005); Treas. Reg. § 1.752-2(a), 1.752-3 (2016).

113. *See* I.R.C. § 731(a)(1), (c), 732(b) (2012); I.R.C. §1223(1) (2012 & Supp. 2018).

114. *See* I.R.C. § 168(i)(7) (2012 & Supp. 2018); I.R.C § 197(f)(9)(A)(i)–(iii) (2012); I.R.C. § 362(a), (d)–(e) (2012 & Supp. 2018), I.R.C. § 1032 (2012); I.R.C. § 1223(2) (2012 & Supp. 2018); Prop. Treas. Reg. § 1.168-2(d)(3), 49 Fed. Reg. 5940, 5946 (Feb. 16, 1984); *id.* § 1.168-5(b)(6)–(7), at 4964–65.

115. If the assets are depreciable, then the corporation would depreciate the assets under the same depreciation schedule used by the LLC to the extent that the tax basis of the assets carried over from the LLC. Depreciation on any additional tax basis that resulted from the recognition of the gain by the LLC is determined as if the corporation newly acquired the property. *See supra* note 114.

cash flow distribution provisions that resulted in one member receiving a disproportionate share of distributions over the years. The operating agreement contained provisions that met the requirements of § 704(b) and, therefore, tax allocations had substantial economic effect.[116] As a result, the three members' tax basis in the LLC is $2,000,000, $8,000,000, and $8,000,000, respectively. These figures include the members' share of the LLC debts of $5,000,000 each. Consequently, the members' capital accounts, on a tax basis, equal a deficit of $3,000,000 for one member and positive capital accounts of $3,000,000 for the other two members. Upon reclassification to a corporation, the LLC will not recognize any gain because its liabilities do not exceed the basis of the assets. It is possible, however, that the member who received the disproportionate distributions will have to equalize his capital account with those of the other members by means of either a special allocation of income, capital contribution, or be willing to receive less than an equal share of corporate stock in the liquidation of the partnership. Otherwise, the previous tax allocation may be disrespected as lacking substantial economic effect.[117]

The latter example illustrates a dilemma for entities that have special allocation provisions that meet the substantial economic effect test of § 704(b). The corporate form is not well-suited for creative, disproportionate distributions provisions. Owners may agree to such

---

116. *See generally* Treas. Reg. §§ 1.704-1(b)(2)(ii)(b)(2)–(3), (b)(2)(ii)(d), (b)(2)(iii), (b)(2)(iv) (2017), 1.704-2 (2016); Friedman, *supra* note 107, at 792.

117. *See supra* note 107 and accompanying text. These rules are designed to assure that partnership allocations have real economic consequences. In the example presented, one member received more cash than the other members, yet the LLC's income was allocated equally among its three members. If the member who received disproportionate distributions suffered no economic consequences as a result, then in substance, she should have been allocated income commensurate with the distributions she received. Therefore, these rules require, in the circumstances described above, that upon liquidation of the partnership this member will suffer the consequences of having taken a share of distributions in excess of her respective share of income. The receipt of disproportionate distributions will assure that this member's book capital account is less than the book capital accounts of the other members. As a result, liquidation in accordance with capital accounts will be disproportionate. The member can make a capital contribution to equalize her capital account with those of the other members. It is also possible that a remedial allocation of income can be made to that partner to equalize her capital account with those of the other members in certain circumstances. See *supra* note 106 and accompanying text, for a discussion of the remedial allocation method.

provisions for a variety of reasons. For example, disproportionate distributions may reflect a member's contribution to a particular segment of the business or reflect a preferred return for financing. It may be possible that such provisions, if they remain in place after reclassification, are considered to be a form of tracking stock, preferred stock, or some other type of equity that the corporate form can accommodate.[118] It is also possible that such disproportionate returns are considered a form of compensation, interest, or some other payment to a person in a non-shareholder capacity, which would be counterproductive to the objective of corporate reclassification. Such circumstances may require a revision of the arrangements among the members to effectuate the change in classification.

In certain circumstances, the entity's owners may find it advantageous to change the entity's form under traditional methods. The incorporation of an unincorporated enterprise can take place in one of three ways, with the tax results dependent on the method chosen. First, steps that mirror the deemed effects of an elective change in classification or a change in status under a state conversion statute can effectuate incorporation. That is, the existing entity can contribute its assets and liabilities to a newly formed corporation in exchange for stock and then distribute the stock to its owners in complete liquidation—a so-called assets over transaction.[119] If this is the desired approach, then there is no apparent reason to go through the formalities of this process if a state law conversion statute exists. If no conversion statute exists, then this process may be advisable if corporate status is desirable as a matter of state law. Second, the existing entity can liquidate by distributing its assets and liabilities to its owners who then contribute such

---

118. Tracking stock is stock whose value tracks a specific segment of the corporate enterprise or a subsidiary of the parent company. The tax implications of such stock are unsettled. *See New York State Bar Association Tax Section Corporations Committee and Reorganizations Committee Report Regarding "Tracking Stock" Arrangements*, 43 TAX L. REV. 51 (1987). Preferred stock, other than non-qualified preferred stock, may be received tax-free in a § 351 exchange. *See* I.R.C. § 351(g) (2012). Non-qualified preferred stock is preferred stock that provides its holder or a related party certain redemption rights or whose dividend varies "with reference to interest rates, commodity prices, or similar indices." *See id.* § 351(g)(2)(A)(iv).

119. *See* Rev. Rul. 84-111, 1984-2 C.B. 88; Nick Gruidl, *Incorporating a Partnership or LLC: Does Rev. Rul. 84-111 Need Updating?*, TAX ADVISER (Apr. 1, 2007), https://www.thetaxadviser.com/issues/2007/apr/incorporatingapartnershiporllcdoesrevrul84-111needupdating.html.

assets and liabilities to a newly formed corporation in exchange for stock—a so-called assets up transaction.[120] Finally, the owners of the entity can contribute their equity interests to a newly formed corporation in exchange for its stock—a partnership interest transfer.[121] The assets up and partnership interest transfer methods can result in tax results, particularly with respect to tax basis, different from those that would result from a reclassification by either an election or by means of a state conversion statute.[122] Whether such disparate results are favorable will depend on the facts and circumstances peculiar to an entity.

The immediate effects of an entity's conversion to C corporation status will depend on the type of entity being converted and the circumstances particular to that entity. Similarly, the tax consequences of reconverting the entity back to pass-through status will be dependent upon several variables, including whether certain advantages enjoyed by the pass-through entity prior to conversion will be lost.

---

120. Gruidl, *supra* note 119.

121. *Id.* Because the existing entity is now entirely owned by the corporation, the partnership ceases to exist, and the assets and liabilities of the entity are now held in corporate form. A partnership must have two or more owners. *See* I.R.C. § 7701(a)(2) (2012 & Supp. 2018); Treas. Reg. § 301.7701-2(a) (2016).

122. In brief, the two methods may yield different results because the rules discussed previously will apply to different assets and in a different order depending on the transaction's form. In an "assets up" approach, the basis of the assets distributed will be the partners' basis in their interests in the partnership less any money received. Upon contribution of these assets to the corporation, the former partner receives a basis in the shares received equal to the basis of the assets contributed less any liabilities assumed by the corporation. The corporation will take the same basis in the assets as that of the partners. This method may be favorable if there is a significant disparity between the partners' basis in the partnership and partnership's basis in its assets. In the "partnership interest transfer" approach, the basis that former partners receive in the shares is the adjusted basis of their partnership interests less liabilities assumed by the corporation. The corporation's basis in the assets is the basis of the partnership interests contributed to it by the shareholders. See *supra* note 119 and accompanying text, for a detailed discussion of the differences between the various methods. *See also* John B. Truskowski, *Cross Species Conversions and Mergers*, 65 TAX LAW. 591, 591–608 (2012). See *supra* notes 90–94 and accompanying text, for a discussion of the rules applicable to reclassifications by election or by the use of state law conversion statutes.

IV. RECONVERSION TO PASS-THROUGH STATUS

The Tax Cuts and Jobs Act did not have broad Congressional support; therefore, the changes the law instituted may prove ephemeral.[123] It should come as no surprise that if Democratic control of Congress and the White House is achieved soon, many of the provisions that favor the corporate form could be scaled back, if not entirely eliminated. Consequently, the due diligence that precedes the decision to convert to C corporation status should extend to the possibility that pass-through status becomes desirable in the not-too-distant future.

A. S Corporation vs. Partnership

The reinstitution of pass-through status for an entity that is taxed as a C corporation will have to be accomplished, most likely, through an S corporation election—a problematic result if the partnership form is more advantageous. If an existing partnership or LLC retained its state law status and merely elected to be reclassified as a corporation under the regulations, then a subsequent election to reclassify the entity back to a partnership will result in a deemed liquidation of the corporation.[124] If the conversion to corporate status took place under state law, then an actual corporate liquidation would have to occur.[125] In either case, the tax results are similar and unfriendly. The

123. *See supra* note 3; *see also* Richard Rubin, *Partisan Vote on Tax Bill Is Warning Sign*, WALL ST. J., Dec. 23, 2017, at A4.

124. Note that a reclassification election cannot be made until five years have lapsed from the previous classification election. *See supra* note 83 and accompanying text. The corporation is deemed to have transferred all its assets and liabilities to the shareholders who in turn contribute the assets and transfer the liabilities to a newly formed partnership. Treas. Reg. § 301.7701-3(g)(1)(ii) (2006).

125. The mechanics of the corporate liquidation and formation of the new entity would depend on the form chosen to implement the change in entity form. For example, the shareholders could form an LLC and merge the corporation into the LLC, or the transaction could be structured to mirror the results of the deemed liquidation that results from the reclassification election noted at *supra* note 124. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 97-01-029 (Oct. 2, 1996). Alternatively, the corporation could avail itself of a state conversion statute, if applicable. Presumably, the use of a state law conversion statute would have the same tax consequences as those that result from a reclassification election. *See supra* notes 93–96 (discussing I.R.S. guidance that the conversion to corporate status under a state law conversion statute has the same consequences as a reclassification election).

corporation recognizes gain or loss as if the corporation sold its property to the shareholders in an amount equal to the properties' fair market value.[126] Therefore, if the corporate assets' value exceeds their tax basis, then the corporation immediately recognizes gain. The shareholders, in turn, recognize gain or loss on the liquidation based on the difference between the fair market value of the property received and the tax basis of their stock.[127] The new partnership would obtain a tax basis in the assets equal to the assets' fair market value.[128] Consequently, a corporate liquidation would result in immediate gain recognition by both the corporation and its shareholders for corporations holding assets with significant built-in gains.

A corporate liquidation's harsh consequences are avoided if future pass-through status is accomplished by retaining the corporate form under the auspices of Subchapter S. Yet conversion of a C corporation to an S corporation, although less problematic than a conversion of a C corporation to a partnership, has its own difficulties.[129] First, this strategy could be problematic if the corporation is not eligible to make an S corporation election. A C corporation that has more than one class of stock or whose shares are held by ineligible shareholders, for example, would have to take steps to make itself eligible, or be trapped in C corporation solution.[130]

Second, the election of S status by C corporations is not without consequences. To be sure, such consequences are not as draconian as those that follow a corporate liquidation, but they are not insignificant.[131] An S election applicable to an entity that previously was a C corporation will subject the corporation to tax on the built-in gains of

126. I.R.C. § 336(a) (2012).

127. I.R.C. § 331(a) (2012 & Supp. 2018).

128. The shareholders' tax basis in the property received would equal the property's fair market value. *See* I.R.C. § 334(a) (2012). The partnership would then inherit that basis as a result of the contribution of such property in formation of the partnership. *See id.* § 723.

129. *See supra* notes 85–86 and accompanying text.

130. *See infra* notes 144–46 and accompanying text. It is common for shareholders of closely held companies to transfer shares to a trust to minimize wealth transfer taxes. The trusts' terms may preclude the eligibility of such trusts to hold S corporation stock. *See generally* I.R.C. § 1361(c)(2), (d) (2018).

131. Note that, absent I.R.S. consent, an S election cannot be made within five years of the termination of a previous S election. *See supra* note 83 and accompanying text.

the corporation that are recognized within five years of the effective date of the S election and a tax on passive earnings in certain circumstances.[132] Moreover, if the corporation uses the LIFO (Last In, First Out) method of inventory costing, then the amount by which its inventory under the FIFO (First In, First Out) costing method exceeds the amount of its inventory under the LIFO costing method is recognized as gross income to the corporation in its last year as a C corporation.[133] Finally, future distributions to shareholders that are allocable to the earnings and profits accumulated by the C corporation are taxable to the shareholders as dividends.[134]

B. Loss of Partnership Advantages

For entities that, prior to conversion to C corporation status, were partnerships, the retention of the corporate form coupled with an S corporation election will cause the entity to lose many of the advantages that the entity had enjoyed in comparison to S corporations. These advantages may or may not be relevant to a particular entity, but on the other hand, they may have been important to the partners prior to the conversion to C corporation status. If so, careful consideration should be given to the potential loss of these advantages.

In addition to the two advantages previously discussed, flexibility in the allocation of tax items and the inclusion of the entity's debt in the owners' tax basis, partnerships offer many other advantages over S corporations.[135] Among the more salient differences between the two forms is the treatment of book-tax disparities with respect to contributed property, greater flexibility in capital structure, and certain advantages for partners who desire to exit the business. In many circumstances, these advantages are not particularly relevant to the entity or its owners, and in certain respects, the S corporation has its own advantages over a partnership. The potential loss of these benefits, however, should not be ignored. If minimal, then so be it, but if significant,

---

132. *See generally* I.R.C. § 1374 (2012 & Supp. 2018); I.R.C. § 1375 (2012).

133. *See* I.R.C. § 1363(d) (2012). The tax is payable in four equal annual installments, without interest, beginning with the due date of the tax return for the corporation's final year as a C corporation. *Id.* § 1363(d)(2).

134. Distributions are sourced first to earnings accumulated during the period the corporation was an S corporation. *See* I.R.C. § 1368(c) (2012 & Supp. 2018).

135. *See supra* notes 106–07 and accompanying text.

care should be exercised before a decision is made to relinquish such benefits.

1. Book-Tax Disparities

The transferee entity, whether taxed as a partnership or corporation, generally takes the transferor's tax basis in the assets contributed to it.[136] As a result, a cash contributing member is at a disadvantage because, assuming the assets have appreciated, the assets' tax basis will not reflect the appreciated value of the assets. The partnership tax rules, however, provide a mechanism for obtaining some or all of such benefits thus reducing the after-tax cost of capital for a cash contributor. Section 704(c) requires that, with respect to contributed property, a partner's distributive share of income, gain, loss, and deductions be computed to account for the variation between the property's adjusted tax basis and its fair market value.[137] This provision's objective is to prevent the shifting among the partners of the tax consequences inherent in a property's built-in gain or loss at the time of contribution.[138] Economically, the cash contributing partner should be entitled to her share of depreciation on $100 of assets. Section 704(c) will provide the cash contributing partner with a disproportionate share of depreciation deductions to account for the difference between the tax basis and the value of the asset.[139] Although applicable to all items of income, gain, deduction, and loss, the principal effect of section 704(c) will be found on cost recovery deductions.[140]

For example, assume that in a two-person equal partnership, partner A contributes depreciable property with a fair market value of $100 and a tax basis of $50, and partner B contributes $100 in cash. Assume that the property is depreciated over five years on a straight-

---

136. *See* I.R.C. § 362(a) (2012 & Supp. 2018); I.R.C. § 723 (2012).

137. I.R.C. § 704(c) (2012 & Supp. 2017); Treas. Reg. § 1.704-3(a)(1) (2017). The regulations state that the principles of § 704(c) apply to allocations with respect to property for which differences between book values and tax basis are created due to revaluations of property. *See id.* § 1.704-3(a)(6)(i).

138. Treas. Reg. § 1.704-3(a)(1) (2017).

139. *See supra* note 106.

140. For example, contributions of receivables or the transfer of accounts payable by cash basis partners will trigger § 704(c) upon collection or payment. Treas. Reg. § 1.704-3(a)(4) (2017).

line basis, taxable income is zero before depreciation, and no distributions are made to the partners. Each partner's book capital account will reflect the value of his contributions, $100 each.[141] For tax purposes, the tax basis of the partners' capital accounts is $50 and $100 for partner A and partner B, respectively. The partnership will have depreciation deductions of $10 per year for five years for tax purposes. For book purposes, however, depreciation is determined by recovering the fair market value of the property at the time of contribution - $20 per year.[142] For book purposes, each partner will be allocated $10 of depreciation. The tax depreciation of $10 will be allocated entirely to the cash contributing partner to eliminate the disparity between partner A's book and tax capital accounts. At the end of five years, partner A will have book and tax capital accounts of $50. Partner B likewise will have book and tax capital accounts of $50.[143]

2. Capital Structure

Partnerships have several advantages over S corporations in settling on an optimum capital structure. These advantages relate both to the number and type of potential financiers as well as the nature of the capital invested. An S corporation is limited to 100 shareholders while there is no limitation on the number of partners in a partnership.[144]

141. Book capital accounts reflect the fair market value of contributed property. *See supra* note 107.

142. *See supra* note 107.

143. Partner B will be allocated $10 of book depreciation and $10 of tax depreciation for five years, thereby reducing both her book and tax capital accounts from $100 to $50. Section 704(c) does not assure this result because of the ceiling rule. For example, if the property contributed had a tax basis of only $40 then tax depreciation would equal $8 per year, not enough to allocate the full $10 to partner B. The ceiling rule may be overcome by use of curative or remedial allocations if the partnership elects to do so. The application of the ceiling rule offers planning opportunities because the ability to select among three methods with which to determine § 704(c) allocations provides the partners the choice of leaving the ceiling rule in place if circumstances dictate that it is favorable to do so. See *supra* note 106, for a discussion of the ceiling rule and alternative methods, and the method by which § 704(c) allocations may be made.

144. I.R.C. § 1361(b)(1)(A) (2012 & Supp. 2018). As a practical matter this difference is more apparent than real. Partnerships tend to be vehicles for closely held businesses because, except for those whose income is derived from certain statutorily prescribed sources, publicly traded entities will lose their flow-through status. *See*

With respect to the type of equity investors available, shareholders in S corporations are limited to individuals who are citizens or residents of the United States, certain trusts, and tax exempt § 401 and § 501(c)(3) organizations.[145] Therefore, S corporations are precluded from obtaining equity financing from foreign sources and C corporations. A partnership is not restricted in the type of persons or entities comprising its membership. In addition to restrictions on the number and type of equity participants, S corporations are somewhat circumscribed in their opportunity to structure creative equity instruments. Although differential voting rights are permissible, an S corporation may issue only one class of stock.[146] This requirement precludes the use of special allocations, preferred returns, and other features that enable an entity to adjust its cost of capital to a perceived optimum.

Partnerships also have various alternatives in the use of debt financing not enjoyed by S corporations. S corporations are likely to be much more reticent in the use of creative debt financing that may include participation features, conversion privileges, options, and other equity flavored attributes because they face the loss of their S status if the putative creditor is treated as a shareholder.[147] The use of so-called straight debt will avoid any second class of stock issue, but straight debt allows for little creativity.[148]

The restrictions on the number of shareholders and the one class of stock requirement severely impede an S corporation in its ability to tailor executives' compensation arrangements. Deferred compensation arrangements, such as phantom stock plans, will not violate these requirements and may provide a reasonable substitute for equity.[149]

I.R.C. § 7704 (2012); *supra* note 5 (discussing the term S corporation). Moreover, the restriction on the number of shareholders is easily avoided by conducting the business through a partnership comprised of multiple S corporation partners. The I.R.S., in Rev. Rul. 94-43, 1994-2 C.B. 198, has sanctioned this technique and revoked conflicting authority. *See also* I.R.S. Priv. Ltr. Rul. 2015-44-020 (July 21, 2015).

145. I.R.C. § 1361(b)-(c) (2012 & Supp. 2018).

146. *See id.* § 1361(b)(1)(D), (c)(4).

147. If putative debt is deemed equity, then the corporation may violate the one class of stock requirement. *See supra* note 146 and accompanying text. Options and conversion features will not, by themselves, terminate an S election but will do so if exercised by ineligible persons. *See supra* note 145 and accompanying text.

148. *See* I.R.C. § 1361(c)(5)(B) (2012 & Supp. 2018).

149. *See* I.R.S. Gen. Couns. Mem. 39,750 (Aug. 11, 1988); I.R.S. Priv. Ltr. Rul. 88-34-085 (June 2, 1988); Treas. Reg. § 1.1361-1(b)(4) (2008).

But contractual rights pursuant to a deferred compensation arrangement may offer less security than the property rights embodied in the equity itself, and perhaps more importantly, a psychological distinction may be drawn by the recipient between a contractual right and an actual equity stake in the business.

Equity interests that are issued in exchange for services will result in taxable compensation to the recipient in both partnership and S corporation settings.[150] Yet partnerships offer two advantages over S corporations in this respect. First, a partnership may tailor a capital interest to achieve its operational objectives through issuance of a capital interest that provides preferred returns or returns tied to the profitability of particular segments of the business—a possibility precluded for S corporations by the one class of stock requirement.[151]

Partnerships can also issue an employee, in most settings, a profits interest in the entity without immediate tax consequences. In general, the receipt of property in connection with the performance of services results in taxable compensation income to the service provider and a corresponding compensation deduction to the service recipient.[152] The tax treatment of the receipt of a profits interest in exchange

150. Absent an election by the service provider to the contrary, grants of non-transferable equity interests that are subject to substantial risk of forfeiture will not result in a taxable event to either the service provider or the service recipient. *See* I.R.C. § 83 (2012 & Supp. 2017). *But see infra* note 152 (noting that the Tax Cuts and Jobs Act precludes such an election by recipients of restricted stock units).

151. *See supra* note 146 and accompanying text.

152. I.R.C. § 83(a), (h) (2012 & Supp. 2017). The regulations also require the service provider, to deduct the compensation payment, to meet certain payroll reporting requirements. Treas. Reg. § 1.83-6(a)(2) (2003). The amount of income recognized by the service provider is the excess of the fair market value of the property received over the amount paid by the service provider for such property. I.R.C. § 83(a) (2012 & Supp. 2017). Fair market value is determined without regard to restrictions other than those that by their terms will never lapse. *Id.* Generally, a restriction that allows the property recipient to sell the property only at a price determined under a formula will cause the property to be valued pursuant to that formula. *Id.* § 83(d)(1). The fair market value of the property is determined at the time that the service provider's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier. *Id.* § 83(a)(1). Whether a substantial risk of forfeiture exists is a factual question based on all the facts and circumstances. Subjection of the service provider's entitlement to the property to continued employment, the attainment of performance targets, or compliance with covenants not to compete creates a substantial risk of forfeiture. *See* Treas. Reg. § 1.83-3(c)(1)

for services has had a contentious history.[153] The I.R.S. clarified the status of profits interests with the issuance of Revenue Procedure 93-27, which provided that the receipt of a profits interest for services rendered for the partnership's benefit in a partner capacity or in anticipation of being a partner would not be treated as a taxable event.[154] A profits interest is a partnership interest, other than a capital interest, defined as an interest in the partnership that would yield proceeds to its holder if all the assets of the partnership were sold at their fair market value and the proceeds of such sale were distributed in complete liquidation of the partnership.[155] The Tax Cuts and Jobs Act did not disturb the general tax treatment of these profits interests; although, it did limit some of the tax advantages enjoyed by holders of these interests.[156]

Partnerships do have their drawbacks with respect to compensatory arrangements. As discussed subsequently, S corporations have

---

(2014). The time the property's fair market value is determined is also the time the income is recognized, and the service recipient can take the corresponding deduction. I.R.C. § 83(a), (h) (2012 & Supp. 2017). The service provider may elect to include the value of property in income upon receipt notwithstanding the presence of a substantial risk of forfeiture. *See id.* § 83(b). Concomitantly, this election accelerates the timing of the service recipient's deduction. *See id.* § 83(h). Such an election may be warranted if the amount of income that is recognizable upon receipt of the property is insignificant or substantial appreciation of the property is expected to occur prior to the lapse of the substantial risk of forfeiture. The Tax Cuts and Jobs Act prohibits a recipient of restricted stock units from making a § 83(b) election. *See generally id.* § 83(i). The Act also enacted a new elective provision pursuant to which recipients of equity-based compensation under the terms of a broad-based plan of a non-publicly traded corporate employer may defer income recognition for five years after the property becomes transferable or is no longer subject to a substantial risk of forfeiture. *See generally id.*

153. *See* Matthew A. Melone, *Success Breeds Discontent: Reforming the Taxation of Carried Interest – Forcing a Square Peg into a Round Hole*, 46 DUQ. L. REV. 423, 452–62 (2008).

154. Rev. Proc. 93-27, 1993-2 C.B. 343.

155. *Id.*

156. *See* I.R.C. § 1061 (2017). This provision extends the holding period for long-term capital gain treatment for gains derived by partners from certain profits interests received for services to three years from one year. *Id.* Special rules prevent the avoidance of the rule through the sale in interests to which the provision applies.

certain advantages, albeit modest, over the partnership form in this respect.[157] Similarly, partners enjoy advantages over S corporation shareholders—though not universally so—when the time comes for the owners to sell their interests in the business.

3. Exit Strategies

Tax practitioners should always consider that participants may desire to end their involvement in the business for various reasons. Sellers of partnership interests enjoy a marketing advantage over a selling shareholder in that a potential buyer of a partnership interest may reflect any premium paid for the interest in the basis of the assets within the entity.[158] Moreover, in many closely held firms, due to contractual restrictions or market realities, the partnership itself offers the

---

157. An S corporation does have several advantages in this respect, however. S corporations can offer the full complement of qualified employee fringe benefits to employees owning not more than two percent of the corporation's stock—a potentially valuable benefit to executives with minor equity holdings. I.R.C. § 1372 (2012); *see also infra* notes 167–68 and accompanying text. Moreover, in granting a capital interest to an employee, a partnership will be deemed to have sold a pro-rata portion of its assets in exchange for services, resulting in a compensation deduction that is partially offset by gain on the sale of assets. *See generally* WILLIAM S. MCKEE ET. AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 5.01 (2d ed. 1990). An S corporation will obtain the compensation deduction without the attendant deemed asset sale. I.R.C. § 1032 (2012); Treas. Reg. § 1.1032-1(a) (1956). For example, assume that an S corporation and a partnership have identical balance sheets whose net assets have a tax basis of $1,100,000 and a fair market value of $1,950,000. Both entities would obtain a compensation deduction of $98,750 (5% of $1,950,000). The partnership, but not the S corporation, will recognize an immediate gain of $42,500 (5% of ($1,950,000 - $1,100,000)) on the transfer of the 5% interest that is allocable to existing members because the partnership is deemed to have sold 5% of its assets. The partnership will have a corresponding increase in the tax basis of its assets.

158. *See generally* I.R.C. § 743 (2012 & Supp. 2017); I.R.C. § 754 (2012). This provision is elective and generally would not be made if the partnership property had depreciated in value. If, however, the partnership has a built-in loss in excess of $250,000 with respect to its property or, as a result of the Tax Cuts and Jobs Act, if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value immediately after the transfer of the partnership interest, then such adjustment is mandatory. I.R.C. § 743(b), (d) (2012 & Supp. 2017). Investment partnerships may elect to avoid the mandatory application of § 743, and if such an election is made, the transferee partner is disallowed her share

only market for the interest. Partnership redemptions offer several advantages over S corporation stock redemptions.[159]

---

of losses until such share of losses exceeds the loss recognized by the transferor partner on the transfer of the interest. *Id.* § 743(e)(2). For this purpose, an investment partnership is a partnership that would be classified as an investment company under the Investment Company Act of 1940 were it not exempted under either § 3(c)(1) or § 3(c)(7) of that Act. *Id.* § 743(e)(5)(B). In certain circumstances, this advantage is muted if most or all the S corporation stock is purchased by a corporate acquirer through the use of a § 338(h)(10) election. *See* I.R.C. § 338(h)(10) (2012 & Supp. 2018). This election results in the re-characterization of the stock sale by the shareholders as an asset sale by the S corporation followed by the immediate liquidation of the S corporation. *See id.* § 338(h)(10)(A); Treas. Reg. § 1.338(h)(10)-1(d)(5) (2007). The gain recognized on the deemed asset sale by the S corporation will increase the shareholders' tax basis in their stock, thereby reducing the gain that such shareholders would recognize on the deemed liquidation of the corporation by a like amount. *See* Treas. Reg. § 1.338(h)(10)-1(d)(5)(i) (2007). If the character of the gain to the S corporation on the deemed asset sale is capital gain, then the shareholders should be ambivalent as to whether the transaction is characterized as the stock sale that it was or is deemed a sale of assets by the corporation followed by its immediate liquidation.

159. A partnership may elect to increase the basis of its assets for any premium paid to the departing member. *See generally* I.R.C. §§ 734, 754 (2012) (providing rules to govern adjustments to basis of partnership property). These adjustments are analogous to the adjustment made on behalf of an acquiring partner discussed at *supra* note 158 with several distinctions. Unlike section 743 adjustments that are made for the benefit of an acquiring partner, this basis adjustment benefits the remaining partners of the partnership. In addition, certain differences exist between the two provisions in the mechanics of allocating the adjustments. *Compare* Treas. Reg. § 1.755-1(b)(1) (2016), *with* § 1.755-1(b)(2). Section 734 adjustments, unlike their § 743 counterparts, affect the partners' capital accounts maintained for § 704(b) purposes. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4) (2017). A partnership also has the ability to liquidate a partner's interest with property distributions without negative tax consequences. Unlike S corporation distributions, no income or loss is recognized by a partnership as a result of property distributions. I.R.C. §§ 311(b), 731(b) (2012). Several exceptions to the general non-recognition rules exist, the most significant of which are liquidating distributions that result in a shift of so-called hot assets between the departing member and remaining members; certain distributions of marketable securities, cases in which only cash, unrealized receivables and inventory are distributed; and in situations where the distributed property was contributed by another member within five years of the distribution. *See generally id.* §§ 731(a)(2), 731(c), 737(a). Service partnerships—those for which capital is not a material income producing factor—also enjoy the ability to structure a portion of payments to a departing general partner as either distributive shares of partnership income or guaranteed pay-

4. S Corporation Advantages

Although the partnership form is generally favorable to exiting participants, the S corporation form does have its own advantages. One advantage enjoyed by S corporation shareholders over partners in a partnership is their ability to exchange their shares tax free pursuant to the corporate reorganization provisions.[160] Partners may receive stock tax free only if the transaction qualifies under § 351.[161] Another advantage, albeit limited, enjoyed by S corporation shareholders is their ability to obtain ordinary loss treatment on the sale of § 1244 stock.[162] S corporations also offer exiting shareholders advantages in terms of income and loss characterization. Gain on the sale of corporate stock is capital gain. While, in contrast, the collapsible partnership rules of § 751 automatically apply if the entity holds so-called hot assets.[163] Hot assets include unrealized receivables and substantially appreciated inventory.[164] If hot assets exist, then any gain attributable to hot assets is re-characterized as ordinary income.[165]

---

ments rather than as payments for property. The practical effect of structuring payments in this fashion is to provide an immediate deduction to the remaining partners for the portion of the purchase price represented by such payments. *See id.* § 736(a).

160. *See generally* I.R.C. § 368 (2012 & Supp. 2018).

161. *See supra* note 100 and accompanying text.

162. The applicability of § 1244 is limited to shareholders to whom the stock was originally issued, and its benefits are capped at $100,000 and $50,000 annually for joint and single filers, respectively. Moreover, its provisions only apply to stock issued prior to the time the corporation's capital and paid in surplus exceeded $1,000,000. Special rules apply to corporations that derive more than 50% of their gross receipts from passive sources and to corporations to which built-in loss property was contributed. *See generally* I.R.C. § 1244 (2012 & Supp. 2014).

163. I.R.C. § 751(a) (2012 & Supp. 2018).

164. *Id.* § 751(c). Unrealized receivables are accrued income items not yet recognized for tax purposes and income that would be treated as ordinary income under a host of recapture rules. *Id.* § 751(c)(1)–(c)(2). Substantially appreciated inventory is inventory whose fair market value exceeds 120% of its basis. Inventory is defined expansively for this purpose. *See id.* § 751(b)(3).

165. *Id.* § 751(a). The Tax Cuts and Jobs Act added a provision whereby the sale of a partnership interest could result in the recognition of income effectively connected with a United States trade or business by partners who are not United States citizens or residents to the extent that the partner would have had effectively connected gain or loss had the partnership sold all its assets at fair market value as of the date of the sale or exchange. *See generally* I.R.C. § 864(c) (2012 & Supp. 2018).

S corporations also offer certain advantages over the partnership form with respect to employee compensation arrangements and employment taxes. As previously noted, the grant of an equity interest by an S corporation will not result in a taxable event to the corporation but, if granted by a partnership, it may result in a taxable event to the partnership.[166] S corporations have certain advantages over partnerships with respect to tax-free employee fringe benefits. Certain fringe benefits are not available to partners or self-employed individuals, most notably, medical insurance.[167] The advantages to S corporations in this respect, however, are muted by the fact that any shareholder who owns more than two percent of the outstanding stock of the corporation or more than two percent of the combined voting power of the stock of the corporation is treated as a partner in a partnership for fringe benefit purposes.[168]

S corporation shareholders who are employed by their corporation could limit their exposure to payroll taxes by minimizing, to the extent reasonable and practical, the compensation they receive as employees of the corporation. A shareholder's share of S corporation income is not considered income from self-employment and, therefore, not subject to self-employment tax.[169] For employment tax purposes,

166. *See supra* note 157.

167. *See, e.g.*, I.R.C. § 79 (2012); I.R.C. § 105 (2012 & Supp. 2018); I.R.C. § 106 (2012 & Supp. 2016); I.R.C. § 119 (2012); I.R.C. § 125 (2012 & Supp. 2018); *id.* § 223.

168. I.R.C. § 1372 (2012).

169. *See* Rev. Rul. 59-221, 1959-1 C.B. 225. The I.R.S. often challenges the reasonableness of such compensation. *See, e.g.*, Spicer Accounting, Inc. v. U.S., 918 F.2d 90 (9th Cir. 1990); Watson v. U.S., 714 F. Supp. 2d 954 (S.D. Iowa 2010); Radtke v. U.S., 712 F. Supp. 143 (E.D. Wis. 1989); Grey v. Comm'r, 119 T.C. 121 (2002), *aff'd* 93 Fed. App'x 473 (3d Cir. 2004); Rev. Rul. 74-44, 1974-1 C.B. 287. With respect to wages, a tax of 6.2% is imposed on both the employee and employer for old-age, survivors, and disability insurance on wages not exceeding an annually adjusted threshold. I.R.C. §§ 3101(a), 3111(a), 3121(a)(1) (2012 & Supp. 2018). The earnings threshold for 2018 is $128,400. *See* SOC. SEC. ADMIN., FACT SHEET, 2018 SOCIAL SECURITY CHANGES (2017), https://www.ssa.gov/news/press/factsheets/colafacts2018.pdf. A tax of 1.45% is imposed on both the employee and employer for hospital insurance, that is Medicare, and this tax is imposed on all wages. An additional .9% tax is imposed on employees on wages in excess of certain thresholds for this purpose. I.R.C. §§ 3101(b), 3111(b) (2012 & Supp. 2018). It may not be practical for a shareholder-employee to minimize her salary if she is not the sole

a partner in a partnership is not an employee of the partnership, but a partner's share of income from any trade or business carried on by the partnership is subject to self-employment taxes.[170] Limited partners, however, are not subject to self-employment tax on their share of partnership income except to the extent they receive guaranteed payments for services.[171] With respect to multi-member LLCs, proposed regulations were issued two decades ago that would classify members, for self-employment tax purposes, as general or limited partners based on several criteria including the level of members' participation in the LLC's business.[172] The owner of a single member LLC that is disre-

---

shareholder of the corporation. The existence of other shareholders will cause a portion of a shareholder's forgone compensation to inure to the benefit of those shareholders to the extent of their percentage interests in the corporation.

170. I.R.C. § 1402(a) (2012 & Supp. 2018); *see also* Rev. Rul. 69-184, 1969-1 C.B. 256. Self-employment taxes contain two components. A tax of 12.4% is imposed for old-age, survivors, and disability insurance on earnings not exceeding an annually adjusted threshold. I.R.C. § 1401(a) (2012 & Supp. 2014); I.R.C. § 1402(b)(1) (2012 & Supp. 2018). The earnings threshold for 2018 is $128,400. *See* SOC. SEC. ADMIN., *supra* note 169. A tax of 2.9% is imposed for hospital insurance, Medicare, and this tax is imposed on all earnings from self-employment. I.R.C. § 1401(b)(1) (2012 & Supp. 2014). An additional .9% tax is imposed on earnings in excess of certain thresholds for this purpose. *Id.* § 1401(b)(2).

171. I.R.C. § 1402(a)(13) (2012 & Supp. 2018). Note that limited partners would be subject to the 3.8% Unearned Income Medicare Contribution if such partners do not materially participate in the business. *See supra* note 26 and accompanying text.

172. *See* Prop. Treas. Reg. § 1.1402(a), 62 Fed. Reg. 1702 (Jan. 13, 1997). These regulations were controversial and, due in part to Congressional pressure, have not been finalized. The Tax Court has focused on the members' level of participation in the business in determining whether self-employment tax is applicable to members' share of an entity's income. *See* Noel P. Brock, *Partners as Employees? Properly Reporting Partner Compensation*, TAX ADVISER (Nov. 1, 2013), https://www.thetaxadviser.com/issues/2013/nov/brock-nov2013.html. Temporary regulations were issued that clarify the application of the aforementioned rules to individuals who are employed by an LLC that is owned by a partnership in which the individual is a partner. In such situations, the regulations state that, with respect to such an individual, the disregarded LLC is not treated as that individual's employer. The individual is subject to self-employment tax similarly to an individual that is employed by an LLC that is owned directly by such individual. Treas. Reg. § 301.7701-2T (2016).

garded for income tax purposes is treated as a sole proprietor for employment tax purposes and therefore, is subject to self-employment tax.[173]

Partnerships offer a flexibility in structuring their affairs that is unavailable to S corporations. Moreover, partners are provided with certain tax advantages in exiting the business. S corporations have their own advantages, but in general, the equities favor the partnership form. Tax law, however, is not practiced in general and the circumstances of the participants and the entities in question will determine whether the erstwhile advantages of one form over the other matter a great deal. If the partnership form was originally chosen for its advantages and those advantages are not marginal, then caution would be advisable before relinquishing the partnership form. Once the entity is converted, the partnership form may be unavailable for the business in the future.

V. CONCLUSION

A reflexive response to the significant tax rate differential between corporate and individual taxpayers is unwise. Whether the conversion of a pass-through entity to a taxpaying corporate entity yields significant benefits depends on a host of factors. Moreover, such benefits must be considered in light of the immediate tax implications that such a conversion will entail and any governance changes that may be required by the conversion. Finally, once converted it may be difficult to obtain the benefits that were derived from the entity's previous pass-through status should the need or desire to return to the status quo ante arise. Due to the fragile nature of the new law's political support, taxpayers would be wise to give this possibility serious thought.

173. Treas. Reg. § 301.7701-2T(c)(2)(iv)(C)(2) (2016). With respect to other employees, single member LLCs that are disregarded for federal income tax purposes are treated as corporations for payroll tax purposes. *See supra* note 87.