Utah State Bar

Business Law Section

Business Tax Boot Camp

December 6, 2019

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Eric graduated with distinction from Georgetown University Law Center with an LL.M. in taxation. Prior to attending Georgetown, he graduated from the University of Kentucky College of Law, where he was a member of the *Kentucky Law Journal*. He received his BA in accounting from Weber State University cum laude. Eric also clerked for the Honorable Glenn E. Acree, chief judge of the Kentucky Court of Appeals.

Eric teaches taxation of individuals in the undergraduate accounting program and has taught Advanced Individual Taxation, State & Local Taxation, Tax-Exempt Entities, International Taxation, Retirement Planning & Employee Benefits and Tax Research & Procedure in the Master of Taxation program. Eric's scholarly interests center on topics related to state and local taxation, individual taxation, and general tax policy. His publications appear in *The Virginia Tax Review*, *The Florida Tax Review*, *The Tax Lawyer*, *The ATA Journal of Legal Tax Research* and *The Journal of Taxation*, among others.

Ryan Pace, MTax, J.D., LL.M.

Ryan Pace joined Weber State University's faculty in 2004. Ryan is a professor of taxation in the School of Accounting & Taxation at the Goddard School of Business & Economics at Weber State University. Ryan also serves as the director of the Master of Taxation Program, Master of Accounting Program, and Center for Tax Education & Research. He teaches undergraduate courses in taxation and business law and graduate courses in partnership taxation, corporate taxation, and mergers, acquisitions and consolidations. Ryan's teaching awards include the 2015 UACPA Outstanding Educator award and the Buehler Teaching Fellowship.

Prior to joining Weber State, Ryan practiced law full-time as a tax attorney in both Arizona and Utah. He is admitted to practice before the United States Supreme Court, Utah Supreme Court and United States Tax Court.

Ryan graduated from New York University with an LL.M. in taxation. He earned his Juris Doctor from Washburn University School of Law, Master of Taxation from Arizona State University School of Accountancy, and his Bachelor of Science degree from the University of Utah. He has authored several peer-reviewed academic articles and is the author of four textbooks on taxation and one on business law.

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I. The Structure of Federal and State Business Tax Law: 30 min (Eric Smith)

- A. Federal
  - i. Income taxes
  - ii. Employment taxes
  - iii. Estate, gift, excise and other Federal Taxes
- B. State
  - i. Income taxes
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  - iii. Property, excise, and other state taxes
  - iv. Importance of the "nexus" issue
- C. Tax Vocabulary
  - i. "Gross income"
  - ii. "Exclusion"
  - iii. "Deduction"
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  - v. "Ordinary income (loss)" "capital gain (loss)"
  - vi. "Amount realized," "gain (loss) realized," "gain (loss) recognized"
- D. Tax Research
  - i. Hierarchy of federal tax authorities
  - ii. Deciphering the Internal Revenue Code

II. Income Taxation of Business Entities Generally: 10 min (Ryan Pace)

- A. Partnerships (including LLCs treated as partnerships)
- B. Disregarded Entities
- C. C Corporations
- D. S Corporations
- E. "Check-the-box" rules

III. Entity Formation, Operations, Distributions, Terminations and Related Tax Issues: 50 min (Ryan Pace)

- A. Formations
  - i. Partnerships
  - ii. C Corporations
  - iii. S Corporations
  - iv. Sample problem #1
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- B. Operations
  - i. Partnerships

ii. C Corporations
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C. Distributions

i. Partnerships
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D. Terminations

i. Partnerships
ii. C Corporations
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(15 minute break)

IV. Sale of Entity Interests: 15 min (Ryan Pace)

A. Partnerships
B. C corporations
C. S corporations

V. Potential Pitfalls and Opportunities: 15 min (Ryan Pace)

A. Constructive Distributions
B. Depreciation and Depreciation Recapture
C. Qualified Business Income Deduction
D. Section 1244 Stock, Section 1202 Stock
E. Business Credits

VI. Mergers, Acquisitions & Consolidations: 30 min (Ryan Pace)

A. Taxable Acquisitions
B. “Tax-free” Acquisitions
C. “Tax-free” Corporate Divisions
D. Affiliated Corporations and Consolidated Returns

VII. Choice of Business Entity Factors to Consider: 15 min (Ryan Pace)

VIII. Conclusion

I. The Structure of Federal and State Business Tax Law

A. Federal Taxes

Federal law imposes several different types of taxes on taxpayers. These include income, employment, estate, gift, and excise taxes.

i. Income taxes

Income taxes are imposed upon individuals, corporations, estates, and trusts (although some corporations, estates, and trusts can be treated as pass-through entities if certain requirements are met). The 2019 ordinary income tax rates applicable to individuals are 10%, 12%, 22%, 24%, 32%, 35%, and 37% depending upon taxable income levels. Corporations are subject to a 21% tax rate. The applicable rates to the taxable income of estates and trusts are 10%, 24%, 35%, and 37% depending upon taxable income levels.

ii. Payroll taxes

"Payroll" taxes is a common term that refers to taxes on salaries and wages that are withheld by an employer and remitted to the government. These withholdings include income, social security and Medicare taxes. Individuals that are self-employed remit quarterly "self-employment" taxes that are meant to be equivalent to what employees have withheld in payroll taxes. The tax rate applicable wages subject to social security taxes is 6.2% and the Medicare rate is 1.45%. Social security tax is not imposed on wages exceeding $132,900 for 2019 ($137,700 for 2020). There is no ceiling on wages subject to the Medicare tax.

iii. Estate, gift, excise and other Federal Taxes

The Code imposes a taxable estates. Each deceased person's estate is entitled to an exclusion amount of $11,400,000 in 2019 ($11,580,000 in 2020). If a deceased person does not use their entire exclusion amount, the unused portion can be shifted over to a surviving spouse. The Code also imposes a tax on taxable gifts. There is an annual exclusion of $15,000 per donee before a donor is subject to the gift tax. If an individual does make a taxable gift, the individual may choose to use up some of the lifetime exclusion amount rather than pay the gift tax.

Federal law also imposes excise taxes on many other transactions (e.g., fuel, tobacco, alcohol, telecommunications, air travel, tanning services, etc.)

B. State Taxes

i. Income taxes

Most states "piggyback" on to the Internal Revenue Code as a mechanism to calculate state income tax liability. Usually, states will start law requires a taxpayer to start with their federal adjusted gross income (for individuals) and make adjustments from there to arrive at state taxable income. Corporations also start with federal taxable income (with a few modifications)

and make adjustments to arrive at state taxable income. Utah imposes a flat income tax rate of 5%.

ii. Sales and use taxes

Most states impose a sales tax on the buyer of goods at retail. Some buyers may be exempt from the sales tax (e.g., government entities, charities, etc.). Some goods may be exempt from sales tax (e.g., certain drugs, medical equipment, sales by suppliers to retailers, etc.) Although a sales tax is imposed on the buyer, the seller has a legal obligation to collect the tax and remit it to the state. Most services are usually not subject to sales tax, but Utah may expand the imposition of sales tax to include more transactions involving services. States impose a base sales tax rate and counties and cities often are able to add their own tax rate on top of the state's rate.

A use tax is imposed when a buyer uses, consumes, or stores property in a state but the buyer may have paid no sales tax (or a sales tax rate lower than the home state's) by purchasing an item from out-of-state. A use tax is imposed on the buyer and remitted to the state by the buyer.

iii. Property, excise, and other state taxes

State and local governments also typically impose property taxes on real property and, in many cases, business personal property. States also typically impose excise taxes on gasoline, cigarettes, alcohol, telecommunications, etc. Some states have estate, inheritance, and real property transfer taxes also. Each state is unique and some research may be necessary when a transaction takes place in a different state.

iv. Importance of the "nexus" issue

Historically, in order for a state to have jurisdiction to impose a tax on a taxpayer, a taxpayer had to establish nexus in the state by having a "physical presence." Recently, the United States Supreme Court ruled that a mere "economic presence" may be enough to establish nexus, thus allowing a state to impose taxes on a transaction even if the seller has no physical presence in the state. This case was *South Dakota v. Wayfair,* 138 S. Ct. 2080 (2018). States are being aggressive in this arena and a consultant would be wise to research specific state guidance before advising clients.

C. Tax Vocabulary

i. "Gross income." Income from whatever source derived minus exclusions specifically allowed by the Code.

ii. "Exclusion." An item of income the Code specifically states is not included in the taxpayer's gross income of a taxpayer and, consequently, not subject to income tax. For example, life insurance proceeds paid to a beneficiary are excluded from the beneficiary's gross income.

iii. “Deduction.” A subtraction from a taxpayer’s income specifically allowed by the Code. Charitable contributions, for example, are a deduction. A deduction lowers a taxpayer’s tax liability by the amount of the deduction multiplied by the applicable tax rate.

iv. “Credit.” A dollar-for-dollar reduction in a taxpayer’s tax liability. The low-income housing credit is an example.

v. “Ordinary income (loss)” and “capital gain (loss).” Items of taxable income (loss) are generally classified into two categories: ordinary and capital. The distinction is important because, for example, long-term capital gains for individuals are taxed at a lower rate than is ordinary income. Income derived from providing services, selling inventory, collecting receivables, collecting rents and royalties, etc., is ordinary income. Individual tax rates on ordinary income are 10%, 12%, 22%, 24%, 32%, 35%, and 37% depending on the individual’s taxable income amount. Capital gain income (or loss) is derived primarily by selling investments or personal property (with some exceptions). The tax rate for individuals on capital gains is 10%, 15%, or 20% depending upon which ordinary income tax bracket the individual is in. After the Tax Cuts and Jobs Act of 2017, a corporation’s tax rate is a flat 21% for both ordinary income and capital gains.

vi. “Amount realized,” “gain (loss) realized,” “gain (loss) recognized.” To determine a taxpayer’s tax liability on the sale or exchange of an asset, a taxpayer must know their amount realized and tax basis (also referred to as “adjusted basis”) in the property they sold. The “amount realized” is the total value of what the taxpayer receives, including money, property, and any debt the taxpayer was relieved of as part of the transaction. If the amount realized is higher than the taxpayer’s tax basis in the asset, the taxpayer has a gain realized. If the amount realized is less than the taxpayer’s tax basis in the asset, the taxpayer has a loss realized. Any gain or loss realized is, by presumption, “recognized” unless the Code provides otherwise. A “recognized” gain must be reported on a taxpayer’s return and the appropriate tax paid. An example of a situation where gain is *realized* but not *recognized* is a qualifying like-kind exchange of real property meeting the requirements of Code Section 1031.

D. Tax Research

i. Hierarchy of federal tax authorities

The Internal Revenue Code is Title 26 of the United States Code and provides the law pertaining to federal taxes. Regulations promulgated by

the Treasury Department interpret the Internal Revenue Code and provide authoritative guidance with both interpretative regulations and legislative regulations. Revenue Rulings and Revenue Procedures issued by the IRS also provide general guidance to taxpayers and also serve as primary authority for taxpayers to rely on. Private letter rulings (PLRs) issued by the IRS to a taxpayer may be relied upon only by the taxpayer to whom the ruling was issued. Nevertheless, a tax adviser may find PLRs, internal IRS memos, letters, etc., useful to see how the IRS analyzes a particular specific factual situation.

ii. Deciphering the Internal Revenue Code

Like other areas of law, the Internal Revenue Code can be quite complex a full of internal cross-references. Nevertheless, it is very helpful to have an understanding of how the Code is organized.

- United States Code
  - Internal Revenue Code (Title 26)
    - Subtitles
      - Chapters
        - Subchapters
          - Parts
            - Subparts
              - Sections
                - Subsections
                  - Paragraphs
                    - Subparagraphs
                      - Clauses
                        - Subclauses

For example if a provision is found in Section 1031(f)(1)(C)(ii), then the applicable reference terminology is

Section 1031
Subsection (f)
Paragraph (1)
Subparagraph (C)
Clause (ii)

II. Income Taxation of Business Entities Generally

A. Partnerships (including LLCs treated as partnerships)

For income tax purposes a partnership is not a corporation, trust, or estate, and has more than one owner. This includes limited liability companies with more than one owner. Partnerships are treated as an aggregation of the owners and thus the entity itself is not subject to taxation.

> **Internal Revenue Code**
>
> **Section 701**. A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

Thus, items of income, loss, gain, expense, etc., "pass-through" ("flow-through") to the partners and are included in or deducted from the partners' gross income. Certain items of income, loss, gain, expense, etc., are treated differently to the partners than is ordinary income or loss. For example, for individuals long-term capital gains are taxed at a lower rate than ordinary income. These items that are treated differently from ordinary income or loss are called "separately-stated items" and are reported to the partners separately from their share of ordinary income or loss. Subchapter K of the Code governs the taxation of partnerships. Most states, including Utah, treat partnerships as pass-through entities similar to federal law. Some states, however, may impose significant annual fees on partnerships or LLCs.

A partnership files an IRS Form 1065 each year. The due date is March 15 for calendar year partnerships. The partnership sends each partner a Schedule K-1, which informs the partner of the partner's share of the partnership's items of ordinary income/loss and separately-stated items. The partner then takes this information and transfers it to the appropriate place on the partner's own tax return.

B. Disregarded Entities

An LLC that has only one owner is considered a "disregarded entity," is not separately subject to income taxation, and files no income tax return. Rather, the items of income, gain, loss, expense, etc., are reported directly on the LLC owner's return. The use of disregarded entities is quite popular since the entities still provide liability protection to the owner without causing adverse tax consequences. Remember, however, that just because these entities are disregarded for federal income tax purposes, they are not disregarded for other types of taxes (e.g., property, sales, etc.). Most states, including Utah, treat entities that are classified as disregarded under federal tax law as disregarded for state income tax purposes also.

C. C Corporations

Once Articles of Incorporation are filed with the appropriate state entity, the corporation is treated as a "C" corporation by default for federal income tax purposes. C corporations are

subject to tax at the entity level at 21%. Subsequent distributions from the corporation's earnings and profits are taxed as dividends to the shareholders. Subchapter C of the Code governs the taxation of C corporations.

C corporations file IRS Form 1120 each year. The due date is April 15 for calendar year corporations.

D. S Corporations

A corporation that qualifies as a "small business corporation" may elect "S" corporation status. S corporations are pass-through entities much like partnerships.

Internal Revenue Code

Section 1363. Effect of election on corporation

(a) General rule. Except as otherwise provided in this subchapter, an S corporation shall not be subject to the taxes imposed by this chapter. . . .

In some very narrow, unique situations, however, the S corporation may be subject to taxation at the entity level if the corporation was formerly a C corporation and the corporation still has earnings and profits from that time. To qualify for small business corporation status, the corporation must:

- be a domestic corporation
- not be an ineligible corporation (some financial institutions and insurance companies are not eligible for S status)
- have no more than 100 shareholders
- have only individuals (and estates, certain trusts, and charities) can be shareholders
- have no nonresident alien shareholders
- have no more than one class of stock

The election is made on IRS Form 2553. S corporations file IRS Form 1120S each year and provide shareholders with a Schedule K-1. The tax return is due by March 15 for calendar year S corporations.

Importantly, Subchapter S cross-references to Subchapter K (partnerships) in many situations. When Subchapter S is silent on an issue, however, *Subchapter C* (corporations) controls.

Internal Revenue Code

Section 1371. Coordination with Subchapter C

(a) Application of Subchapter C rules. In general. Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, Subchapter C shall apply to an S corporation and its shareholders. . . .

E. “Check-the-box” Rules

The Treasury Regulations allow “eligible entities” to elect to be treated differently than their default classification. Eligible entities are generally unincorporated entities that are not trusts or estates. Thus, partnerships and LLCs are allowed to elect to be treated as C corporations. Check-the-box elections are made by checking a box on IRS Form 8832.

Partnerships and LLCs are also allowed to make an S election (and by so doing are deemed to have made the election to be treated as a corporation under the check-the-box rules) as long as they meet the eligibility requirements to make an S election. If this election is desire, the entity files Form 2553 with the IRS. Sometimes clients can often be confused in these situations regarding the fact that their entity is a partnership or LLC for state business law purposes but treated as an S corporation for income tax purposes.

III. Entity Formation, Operations, Distributions, Terminations and Related Tax Issues

A. Formations

The Code allows the transfer of property to a business entity to be accomplished without triggering a taxable gain (or deductible loss) if the transaction meets certain requirements.

i. Partnerships

Generally, gain or loss is not recognized on the transfer of property to a partnership in return for a partnership interest.

Internal Revenue Code

Section 721. Nonrecognition of gain or loss on contribution

(a) General rule. No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. . . .

An exception to the general rule is if the partnership is an “investment company” after the transfer of the property. Basically, investment companies are partnerships or corporations that have at least 80% of their assets in marketable securities and, as a result, the partner or shareholder has “diversified” their investment holdings.

ii. C corporations

The Code allows transfers of property to a C corporation to be accomplished without recognition of gain or loss if certain requirements are met. The law is different than for partnerships, and is a bit more strict.

Internal Revenue Code

Section 351. Transfer to corporation controlled by transferor

(a) General rule. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. . . .

Notice the requirement that the transferor(s) of property be in control immediately after the exchange. Control means that the transferor(s) of property own at least 80% of the voting power and at least 80% of each of all the other class of stock of the corporation.

iii. S corporations

Subchapter S is silent regarding the tax consequences of transferring property to an S corporation in exchange for stock in the corporation. Consequently, the law contained in Subchapter C (governing C corporations) applies.

iv. Sample problem #1

R and J, both individuals, form a business entity where they are the only two owners. R transfers $100 in cash in return for 50% ownership of the entity. J transfers

property with a tax basis of $70 and fair market value of $100 in exchange for 50% ownership in the entity. Discuss the income tax consequences to the entity and owners depending on whether the entity is a partnership, C corporation, or S corporation.

v. Sample problem #2

R and J, both individuals, form a business entity where they are the only two owners. R transfers property with a tax basis of $80 and a fair market value of $100 in exchange for 50% ownership in the entity. J transfers services (and no property) worth $100 to the entity in exchange for 50% ownership in the entity. (For simplicity purposes, let's assume the $100 value of the services is capitalized as an asset by the entity rather than immediately expensed.) Discuss the income tax consequences to the entity and owners depending on whether the entity is a partnership, C corporation, or S corporation.

B. Operations

i. Partnerships

As a pass-through entity, partnerships do not pay income taxes at the entity level. Partners pay taxes on income passed through to them. Each partner receives a Schedule K-1 from the partnership informing them of their share of the partnership's income, gain, loss, credit, etc.

A partnership return (IRS Form 1065) is due by March 15 for calendar year partnerships.

A partner's tax basis in their partnership interest (commonly referred to as their "outside" basis) increases for capital contributions and items of income allocated to them. Their outside basis decreases by distributions to them from the partnership and by deductions and losses allocated to them. A partner's outside basis also increases by the partner's share of an increase in partnership liabilities and decreases by the partner's share of a decrease in partnership liabilities. A partner's outside basis cannot go below zero. Any losses that would otherwise cause a partner's outside basis to go below zero carries forward to subsequent years. A partner needs to know their outside basis particularly when they sell their ownership interest in the partnership.

Importantly, partners must pay tax on their share of partnership income even if the income is not actually distributed to them during the year. Consequently, many partnerships distribute at least enough cash to the partners so they can pay the related tax each year.

Partners have considerable flexibility in allocating items of income/loss. They can even agree on allocating specific items according to different percentages. Nevertheless, the Code requires that any "special allocations" have *substantial economic effect* in order to be respected. In other words, the allocations must have economic impact on the partners and not just a tax avoidance purpose.

ii. C corporations

A C corporation is an entity subject to income taxes separate from its shareholders.

Internal Revenue Code

Section 11. Tax imposed

(a) Corporations in general. A tax is hereby imposed for each taxable year on the taxable income of every corporation.

(b) Amount of tax. The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income.

…

C corporations are not eligible for lower income tax rates on long-term capital gains. Net capital losses are not deductible against ordinary income. Net capital losses can be carried back three years and forward five years. Net operating losses (NOLs) incurred after 2017 are carried forward indefinitely. NOLs incurred prior to 2018 could generally be carried back two years and forward 20 years. NOLs carried forward may be subject to an 80%-of-taxable-income limitation.

C corporations are entitled to special deductions upon receiving a dividend from another corporation. If the recipient corporation owns less than 20% of the dividend-paying corporation, then the recipient corporation receives a deduction equal to 50% of the dividend. If the recipient corporation owns 20% or more, but less than 80%, the recipient corporation receives a deduction equal to 65% of the dividend. If the recipient corporation owns at least 80% of the dividend-paying corporation, the recipient corporation receives a deduction equal to 100% of the dividend.

C corporation shareholders do not increase their stock basis by the income of the corporation and do not decrease their stock basis by losses of the corporation. Moreover, a shareholder's stock basis is generally not referred to as the shareholder's "outside basis."

iii. S corporations

As a pass-through entity, S corporations generally do not pay income taxes at the entity level. In a few narrow situations, an S corporation may be subject to entity-level taxes if the S corporation was once a C corporation and still has earnings and profits from those C corporation years. Those taxes are (1) the LIFO recapture tax; (2) built-in gain tax; and (3) net passive investment income tax.

S corporation shareholders pay taxes on income passed through to them. Importantly, S corporation shareholders must pay tax on their share of the S corporation's income even if the income is not actually distributed to them during the year. Consequently, many S corporations distribute at least enough cash to the shareholders so they can pay the related tax each year. Each shareholder receives a Schedule K-1 from the S corporation informing them of their share of the corporation's income, gain, loss, credit, etc.

An S corporation tax return (IRS Form 1120S) is due by March 15 for calendar year S corporations.

An S corporation shareholder's tax basis in their stock increases for capital contributions and items of income allocated to them. Their stock basis decreases by distributions to them from the S corporation and by deductions and losses allocated to them. Unlike a partner's outside basis in a partnership, an S corporation shareholder's stock basis does not increase or decrease as a result of increases or decreases in the S corporation's liabilities. An S corporation shareholder's stock basis cannot go below zero. Any losses that would otherwise cause a shareholder's stock basis to go below zero carries forward to subsequent years. A shareholder needs to know their stock basis particularly when they sell their stock in the S corporation.

iv. Sample problem #3

R and J are equal owners of an entity. R has a tax basis of $100 in his ownership interest. J has a tax basis of $300 in her ownership interest. The entity experiences the following during the year:

Consulting revenue	$1,000
Long-term capital gain	$ 50
Dividend received	$ 10
Salaries & wages	$ 200
Rent expense	$ 100
Advertising expense	$ 100

Note: The entity owns 15% of the dividend-paying corporation

Discuss the income tax consequences to the entity and owners depending on whether the entity is a partnership, C corporation, or S corporation.

C. Distributions

i. Partnerships

A distribution from a partnership to a partner does not trigger gain at the partnership level. A partner recognizes gain only if the partnership distributes <u>money</u> that exceeds the partner's outside basis. A partner recognizes a loss only in narrow situations in a liquidating distribution.

Internal Revenue Code

Section 731. Extent of recognition of gain or loss on distribution

(a) Partners. In the case of a distribution by a partnership to a partner—
(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and
(2) loss shall not be recognized . . . except . . . upon a distribution in liquidation of a partner's interest in the partnership. . . .

(b) Partnerships. No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

. . .

Partners reduce their outside basis (but not below zero) by the amount of money they receive and by the adjusted basis of any property other than money they receive. The partner's tax basis in the property received is generally a carryover basis and the holding period continues on (i.e., "tacks") The partnership does not get a deduction for distributions to partners.

ii. C corporations

A distribution from a corporation is a dividend to the shareholder if the distribution is from the corporation's earnings and profits. If the distribution exceeds the earnings and profits of the corporation or if the corporation has no earnings and profits, the distribution is treated as a nontaxable return of capital (reduction in stock basis of the shareholder) and capital gain to the extent the distribution exceeds the shareholder's tax basis.

A corporation needs to calculate its earnings and profits balance each year so as to what extent a distribution is a dividend. Earnings and profits of the current year is calculated by starting with the corporation's taxable income (or NOL) and making various adjustments. For example, the corporation would adjust its taxable income upward by any tax-exempt income the corporation receives since, although not taxable, the income increases the corporation's ability to pay a dividend. Likewise, a corporation would decrease taxable income for earnings and profits calculation purposes for the amount of federal taxes paid since federal taxes paid are not deductible for income tax purposes but do reduce the corporation's ability to pay a dividend. The corporation is not entitled to a tax deduction for distributions to shareholders.

Importantly, if a C corporation makes a distribution of appreciated property, gain is triggered at the corporate level. If a C corporation makes a distribution of loss property, however, loss is not recognized. The shareholders recognize a dividend (assuming the corporation has enough earnings and profits) equal to the fair market value of the distribution and they have a fair market value tax basis in the property (along with a new holding period).

iii. S corporations

Shareholders of an S corporation do not recognize gain on distribution unless the distribution exceeds the shareholder tax basis. The S corporation does not recognize gain or loss on the distribution of money, but does recognize gain (which flows through to the shareholders) if it distributes appreciated property. If an S corporation makes a distribution of loss property, however, loss is not recognized. Shareholders reduce their tax basis by the fair market value of property received and they have a fair market value tax basis in the property (along with a new holding period).

iv. Sample problem #4

R and J are equal owners of a business entity. R has a tax basis of $100 in his ownership interest in the entity and J has a tax basis of $300 in her ownership interest in the entity. The entity distributes cash of $200 to R and land to J worth $200. The land has a tax basis of $190 in the hands of the entity immediately before the distribution. Discuss the income tax consequences to the entity and owners depending on whether the entity is a partnership, C corporation, or S corporation.

D. Terminations

i. Partnerships

A partnership terminates when no business, financial operation, or other activities of a partnership are being carried on by any of its partners. A partnership does not recognize gain or loss on the distribution of property in a liquidation. Partners reduce their outside basis by the amount of money received plus the adjusted basis of any property received. Partners recognize gain if the amount of money distributed to them exceeds their outside basis. Partners do not recognize loss unless the only assets they receive are money, unrealized receivables, or inventory and they still have an outside basis remaining after the distribution.

ii. C corporations

Upon a complete liquidation, a C corporation is treated as selling its assets. Thus, gain or loss is recognized to the corporation.

Internal Revenue Code

Section 336. Gain or loss recognized on property distributed in complete liquidation

(a) General rule. Except as otherwise provided in this section or section 337, gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distribute at its fair market value.

. . .

Importantly, a C corporation should retain enough cash to pay any tax liability due for the last year of its existence, including any tax due because of the liquidation itself.

Shareholders of a C corporation are treated as selling their stock in return for the property received.

Internal Revenue Code

Section 331. Gain or loss to shareholders in corporate liquidations

(a) Distributions in complete liquidations treated as exchanges. Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.

. . .

A shareholder's tax basis in the property received is the property's fair market value and the holding period continues on (i.e., "tacks"). The liquidating corporation's tax attributes (e.g., earnings and profits, NOLs, etc.) disappear.

Exceptions exist to the general rules if the liquidation is a complete liquidation of a subsidiary into a parent (owns at least 80% of the subsidiary). In these situations, the liquidating corporation recognizes no gain or loss on the distribution to the parent (but may recognize gain on a distribution to a minority shareholder if there is one). The parent corporation recognizes no gain or loss on receipt of property from the liquidating subsidiary. The liquidating subsidiary's tax attributes carryover to the parent. The parent's tax basis in property received is a carryover basis and the holding period tacks.

iii. S corporations

Subchapter S is silent regarding the tax consequences of an S corporation termination and liquidation. Consequently, the law contained in Subchapter C applies (the corporation is treated as selling its assets and the shareholders are treated as selling their stock). It is important to remember, however, that any gain (and/or loss) recognized by the S corporation upon liquidation passes-through to the shareholders and is not taxed at the entity level.

iv. Sample problem #5

R and J, both individuals, each own 50% of a business entity. The entity distributes three assets in complete liquidation: (1) cash $100; (2) Greenacre (tax basis of $80, fmv of $100); and (3) Blackacre (tax basis of $90, fmv of $100). R receives $50 cash and Greenacre. J receives $50 cash and Blackacre. R's tax basis in his ownership interest is $20 and J's is $110. Discuss the income tax consequences to the entity and owners depending on whether the entity is a partnership, C corporation, or S corporation.

IV. Sale of Entity Interests

A. Partnerships

In general, the sale of a partnership interest generates a capital gain or loss. Nevertheless it is possible for some gain or loss to be classified as ordinary income/loss.

Internal Revenue Code

Section 741. Recognition and character of gain or loss on sale or exchange

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

Notice that Code Section 741 says that gain or loss shall be recognized. Thus, there really is no provision in the Code that allows avoiding recognizing gain or loss on the sale of a partnership interest. The cross-reference to Code Section 751 relating to unrealized receivables and inventory items is important. Basically, to the extent a seller of a partnership interest receives consideration that represents the partner's share of the value of the partnership's unrealized receivables and inventory, the income/loss is classified as ordinary. Any remaining gain/loss is classified as capital.

An important point to remember is that for partnerships the selling partner must include in the partner's amount realized, his share of partnership liabilities.

B. C corporations

Subchapter C does not specifically address the tax treatment to a shareholder upon the sale of C corporation stock. Consequently, other general principles of tax law contained in other sections of the Code apply. C corporation stock is generally a capital asset in the shareholder's hands. (Stock would be an ordinary asset in a securities dealer's hands.) Thus, a shareholder typically recognizes capital gain or loss on the sale of the stock.

C. S corporations

Subchapter S is silent regarding the tax consequences of an S corporation shareholder selling their stock in an S corporation. Consequently, the law contained in Subchapter C applies. Subchapter C also happens to be silent on this issue. Consequently, other general principles of tax law contained in other sections of the Code apply. S corporation stock is generally a capital

asset in the shareholder's hands. Thus, a shareholder typically recognizes capital gain or loss on the sale of the stock.

V. Potential Pitfalls and Opportunities

A. Constructive Distributions

Sometimes, particularly in closely held business entities, the owner causes the entity to pay a personal, nonbusiness expense of the owner. In these cases, the tax law will deem that the business entity made a distribution to the owner and then the owner paid the expense. These are "constructive" distributions. In C corporations, this would likely result in a dividend to the shareholder (assuming the C corporation has earnings and profits). In S corporations and partnerships, the constructive distribution would be a nontaxable reduction in the stock basis (or outside basis), and a capital gain to the extent the distribution exceeds the stock basis or outside basis, as the case may be. Another issue to consider when the business entity pays a personal expense of the owner is the risk of a "piercing-the-veil" argument in any subsequent lawsuit.

B. Depreciation and Depreciation Recapture

The Code provides incentives for businesses to purchase equipment. These incentives are primarily contained in depreciation provisions. Code Section 179 allows a business to expense immediately up to $1,000,000 (in 2019) of qualified property (subject to phase-out after purchases over $2,500,000). Furthermore, the Code frequently allows for "bonus" depreciation and other accelerated depreciation methods. Please be aware that these numbers change, sometimes year-by-year.

One important thing to remember is that when depreciation is taken on eligible property, when that property is later sold, any gain recognized on the sale is considered ordinary income (rather than capital gain) up to the lesser of the depreciation deductions taken or the gain realized on the sale. This is referred to as "depreciation recapture," or sometimes "recaptures on Section 1245 property."

C. Qualified Business Income (QBI) Deduction

The Tax Cuts and Jobs Act provides a new deduction for eligible sole proprietors and owners of pass-through entities. The Act lowered tax rates on corporations from a top rate of 35% to a flat rate of 21%. To give a tax cut to owners of noncorporate entities, the qualified business income deduction (QBI deduction) provides a deduction up to 20% of the taxpayer's qualified business income. This new deduction has turned out to be quite complex in determining limitations and the nature of qualifying business income. For example, income from certain service-related businesses does not qualify.

D. Section 1244 Stock, Section 1202 Stock

To encourage investment in small business, the Code provides some tax breaks for gains and losses on the sale of small business corporation stock. Regarding losses on the sale of qualifying stock, Section 1244 provides that losses can be classified as ordinary losses instead of capital losses up to $50,000 (single) or $100,000 (married filing jointly). If qualifying stock is sold at a gain Section 1202 allows some or all of the gain to be excluded from the seller's gross income.

E. Business Credits

Federal law allows for many business tax credits such as for research activities, electric vehicles, low-income housing, paid family and medical leave, etc. See IRS Form 3800 for a list. Also, the IRS website provides published information regarding these credits.

VI. Mergers, Acquisitions & Consolidations

A. Taxable Acquisitions

Taxable acquisitions can be either asset acquisitions or stock acquisitions. Tax consequences may vary depending upon whether the seller is a sole proprietor, partner, shareholder in an S corporation or shareholder in a C corporation. For purposes of this discussion we will assume that one individual shareholder owns a C corporation.

If the acquisition is a stock acquisition, the selling shareholder typically will recognize capital gain (long-term if the shareholder has owned the stock longer than a year). The corporation that is owned by the selling shareholder does not incur a tax.

If the acquisition is an asset acquisition, the selling corporation will recognize gain or loss on the sale of each asset. Thus, the corporation needs to know its tax basis in its assets sold and the amount of consideration received for those assets. Code Section 1060 requires sellers and buyers in an "applicable asset acquisition" to allocate the purchase price among seven classes of assets according to fair market value so that the seller and buyer's allocations are consistent. The seven classes are:

Class I assets:	cash, checking and savings accounts
Class II assets:	publicly traded stock, U.S. government securities
Class III assets:	accounts receivable, certain debt instruments
Class IV assets:	inventory, property held primarily for sale
Class V assets:	all assets that do not fall into the other six classes
Class VI assets:	Section 197 intangibles other than goodwill and going concern value
Class VII assets:	goodwill and going concern value

Notice that any premium paid above the fair market value of assets is assigned to goodwill and going concern value. The parties report the allocation on IRS Form 8594.

B. “Tax-free” Acquisitions

The Code allows certain acquisitions to be accomplished without the recognition of gain or loss.

Internal Revenue Code

Section 354. Exchanges of stock and securities in certain reorganizations

(a) General rule.—
(1) In general. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

…

Code Section 354 applies to shareholders of corporations involved in reorganizations. Code Section 361 applies to the corporations involved.

Internal Revenue Code

Section 361. Nonrecognition of gain or loss to corporations; treatment of distributions

(a) General rule. No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

. . .

Now, we need to define the term “reorganization.” Code Section 368 does that.

Internal Revenue Code

Section 368. Definitions relating to corporate reorganizations

(a) Reorganization.—
(1) In general. For purposes of parts I and II and this part, the term “reorganization” means—
(A) a statutory merger or consolidation;
(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition,

the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization;

(F) a mere change in identity, form, or place of organization of one corporation, however effected; or

(G) a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

. . .

The seven different types of reorganization are often referred to by the subparagraph they are contained in (i.e., "A" reorg, "B" reorg, etc.).

C. "Tax-free" Corporate Divisions

As with corporate acquisitions, certain structures of corporation divisions can be accomplished in a tax-free manner.

Internal Revenue Code

Section 355. Distribution of stock and securities of a controlled corporation

(a) Effect on distributees.—

(1) General rule. If—

(A) a corporation (referred to in this section as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both . . .,

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c) . . .,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

. . .

The three common forms of corporate divisions are: spin-off, split-off, and split-up.

Example #1, corporate divisions. Sports Corporation manufactures tennis equipment and golf equipment. R and J each own 100 shares of Sports Corporation and are the only shareholders. R and J wish to separate the tennis and golf manufacturing businesses so that each is housed in a separate corporation and owned directly by the shareholders. Thus, Sports Corporation transfers the golf assets into newly-formed Golf Corporation with Sports Corporation as the sole shareholder. Sports Corporation then distributes Golf Corporation stock in a pro-rata manner to R and J. Assume all other requirements of Section 355 are met. What type of corporate division is this?

Example #2, corporate divisions. Sports Corporation manufactures tennis equipment and golf equipment. R and J each own 100 shares of Sports Corporation and are the only shareholders. R and J wish to separate the tennis and golf businesses so that R solely owns the tennis business and J solely owns the golf business. Thus, Sports Corporation transfers the tennis assets to Tennis Corporation. Sports Corporation is the sole owner of Tennis Corporation. Then Sports Corporation distributes the Tennis Corporation stock to R in return for all of R’s stock in Sports Corporation. Assume all the requirements of Section 355 are met. What type of corporate division is this?

Example #3, corporate divisions. Sports Corporation manufactures tennis equipment and golf equipment. R and J each own 100 shares of Sports Corporation and are the only shareholders. R and J wish to separate the tennis and golf manufacturing businesses so that each is housed in a separate, new corporation and owned directly by the shareholders. Thus, Sports Corporation transfers the tennis assets into Tennis Corporation and the golf assets into Golf Corporation. Sports Corporation is the sole shareholder of both Tennis Corporation and Golf Corporation. Then, Sports Corporation distributes both the Tennis Corporation and Golf Corporation stock to R and J in a pro-rata manner and Sports Corporation terminates. Assume all the requirements of Section 355 are met. What type of corporate division is this?

D. Affiliated Corporations and Consolidated Returns

An “affiliated group” of corporations is allowed the privilege of filing a consolidated return. If the affiliated group elects to file a consolidated return, the group is also referred to as a “consolidated group.” The consolidated return regulations are quite voluminous. As a general rule, income and expense on transactions between members of a consolidated group often offset each other on the consolidated return. Regarding sales of property by one member to another, gain or loss recognition is typically postponed until the property is ultimately sold or otherwise disposed of outside the consolidated group. Treasury regulations also address limitations on the a group’s use of net operating losses carried over by a new member that the member incurred while not a member.

VII. Choice of Business Entity Factors to Consider

Many non-tax and tax factors are relevant in choosing the optimal entity for a business enterprise. Non-tax issues include state law requirements (filings, meetings, etc.), liability protection, legal and accounting costs, securities law, etc. Tax issues include formation, qualification for S status (if applicable), tax rates, special allocations, payroll taxes, state taxes, etc. Gathering facts and future goals from clients is critical in determining the optimal choice of business entity. Many of the tax issues discussed in these materials are pertinent when considering choice of entity.

VIII. Conclusion

Nearly every business transaction has some tax consequence. Familiarity with the tax issues and relevant strategies applicable to various entities can add significant value to a business lawyer’s practice. Knowing the core tax laws relating to partnerships, S corporations and C corporations allows greater ability to attract, retain and benefit clients.