S Corporations and Partnerships: Significant Differences in Tax Treatment

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Formation

Basic Rules:

A. Contributions of Property to S Corporation that is 80% owned by contributor(s) are tax free - Section 351

B. Contributions of Property to a Partnership are tax free - Section 721

C. What about services for ownership in Corporation or Partnership?

Scenario 1

•A owns land valued at $2.0M with tax basis of $500,000

•A contributes the land to S Corporation for 50% ownership

•A contributes land to Partnership for 50% ownership

Scenario 2

•A contributes the same land for an 80% ownership in S Corporation but the land has an old and cold mortgage of $1.0M

Section 357(c)

What if the contribution was to a Partnership?

Aggregate liabilities and aggregate basis by Transferor.

Scenario 2 – Basis Results

Corporation – the stock basis is the basis of the contributed property plus gain recognized.

•The basis is $500,000 less $1.0M plus $500,000 or $0

Partnership – the basis is the basis of the contributed property less any debt relief plus any allocable share of partnership debt.

•The basis is $500,000 less $1.0M plus $900,000 or $400,000
•$900K equals $500,000 of built in gain plus 80% of $500,000

Corporate Formation

Some Concerns

• Transitory Ownership – step transaction
•What is a Group? Accommodation Transferor
•80% Control – voting and other classes (attribution?)
•Group with each member getting different classes

Formation

Additional Rules:

- S Corporation does not have the concept of built in gain allocations
- Partnership has concept of built in gain allocations Sections 704(b) and 704(c)

Scenario 3

- B owns 100% of an S Corporation worth $500,000
- A contributes land worth $2.0M with $500,000 basis to S Corporation for 80% ownership
- One year later S Corporation sells the land for $2.0M
- Same transaction but with a Partnership

Scenario 4

- A contributes land worth \$2.0M with \$500,000 basis for 50% ownership in S Corporation AND B contributes cash of \$2.0M for 50% ownership
- What if A got 100% of non-voting stock and B got 100% voting stock?

Same as above but contribution is to a Partnership

The land is sold.

- Corporation – each of A and B has gain of \$750,000
- Partnership – A has gain of \$1.5M; B has zero gain

Scenario 4 (continued)

- After the sale by the S Corporation, the Corporation distributes all assets and dissolves
- On the sale, each of A and B realized gain of \$750,000
- Outside Tax Basis for A increases to \$1,250,000 and Outside Tax Basis for B increases to \$2,750,000
- On liquidation, A receives \$2.0M and realizes gain of \$750,000
- On liquidation, B receives \$2.0M and realizes a loss of \$750,000

Scenario 4 (continued)

- What if liquidation is not in the same year – the capital Gain in year 1 and capital loss in year 2 for B

- How does State of New Jersey treat this?

  - K-1 income bucket
  - Sale of property bucket

- Impact on New Jersey Non Resident

Scenario 5

•A contributes building and land valued at $3.0M ($2.8M building and $200,000 land) and a tax basis of $1.0M for building and $200,000 for land for 50% ownership in an Entity

- B contributes $3.0M cash for 50% ownership of the entity
- S Corporation allocates depreciation along with income/loss pro rata to stock

Special depreciation allocations in the Partnership. The Traditional Method, Traditional Method – ceiling rule method, the curative and the remedial method to allocate the depreciation, additional tax items or even make up tax items

Scenario 5 (continued)

•If 10 years left on life, then book depreciation is $280,000/year;

•50% to B is $140,000/year;

•Limit is $100,000 ($1.0M divided by 10)

•Traditional – specifically allocate the depreciation subject to ceiling rule

•Remedial – must use actual tax item to cure

•Curative - just allocate income to A and depreciation to B

Scenario 6

Contribution to Existing Entity; Reverse 704(c)

Entity owned 50% by each of A and B owns a Business worth $2.0M consisting of goodwill ($1.5M) and assets ($500,000); with a $200,000 tax
basis in the assets

Person C contributes $1.0M for a one-third (1/3) interest

If Entity is an S Corporation, the depreciation continues the same and allocates along with income/loss pro rata to stock ownership

Scenario 6 (continued)
Then Person D comes along to become an owner

- If Entity is a Partnership, then:
- Person C is entitled to depreciation or amortization based on $2.0M value
- Book-up all assets – See Capital Account Maintenance Rules
- Use book depreciation to allocate tax items

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Scenario 6 (continued)
Book depreciation

Goodwill: $1.5M/15 years = $100,000/year; one third is $33,333

Assets: $500,000/5 years = $100,000/year; one third is $33,000

Thus, C is entitled to $66,666 but the goodwill has a zero tax basis and the assets $200,000 yielding a total $40,000 depreciation on one third - $13,333

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Income/Loss Allocation Rules

Basic Rules:

A. S Corporation income or losses are allocated among shareholders in accordance with percentage ownership of stock during the year.

B. Partnership income or losses are allocated as agreed upon prior to the filing of the tax return subject to various rules and "substantial economic effect" compliance – best to have written Agreement.

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Income/Loss Allocation Rules

C. Partnerships have the "varying" interests rules under Section 706(d) which are comparable to the S Corporation allocation rules.

D. The varying interest rules do not prevent persons who are partners for the year to retroactively adjust their shares so long as they comply with Sections 704(a) and 761(d).

E. Additional contributions and shifting ownership?
F. Family Partnership Rules 704(e) – father works/ father guaranties debt; children own and get profits

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Scenario 7

A and B each contribute $1.0M to start up business entity for 50% ownership. The business incurs a loss of $200,000 in year one.

S Corporation allocation of the loss

Partnership allocation of the loss
- Substantial economic effect

What if there was income?
- Allocation among service owners

Scenario 8

Self-Employment Tax

Partnership – all net earnings are subject to self-employment tax

S Corporations – compensation paid to owner is subject to payroll deductions but not the share of earnings

LLC – taxed as partnership? Management control?

LLC – taxed as an S Corp.?

Debt Tax Basis / Loss Allocations

Basic Rules:

Entity level debt does not create outside tax basis for S Corporation shareholder but does create such basis for partners of a partnership.

What if the S shareholder guarantees the debt?

What if there is back-to-back debt?

Scenario 9

- A and B each contribute $100 to entity
- Entity borrows $300 for start up costs of a restaurant
- Entity has a tax loss of $300
- A and B are both active
- What if A and B personally guaranty the debt?
- Can A and B deduct the loss on personal return?
- S Corporation
- Partnership

Debt Tax Basis / Distributions

Scenario 10:

- Entity X is owned equally by A and B
- A and B each have outside tax basis of zero
- Entity X borrows $500 and distributes $100 to each of A and B
- At Risk Rules?
- Do A and B have taxable income?
- Does it make a difference if entity is an S Corporation or a Partnership?

Debt Tax Basis / Distributions

Scenario 11:

Asset Distributions Example

A and B are 50/50 owners of an entity. Entity owns two assets – P with a value of $100 and basis of 60 and Q with value of $100 and zero basis. A and B each have an outside tax basis of $30.

Entity distributes P to A in redemption of A's ownership.

Debt Tax Basis / Distributions

S Corp.

It is deemed that S Corp. sold P at its value - $100. That sale results in $40 gain. The gain is allocated by K-1s to A - $20 and B - $20. A's basis in his stock increases from $30 to $50. A then has $50 of gain because he received property worth $100 in exchange for his stock with a basis of $50. A has 70% of gain.

B who still owns the S Corp. has gain of $20 on the distribution to A. If Entity sells Q and liquidates then the results are that (1) B has $100 of income on the sale and (2) B has a loss of $50 on the liquidation. This is the basis in his stock of $150 ($30 plus $20 plus $100) and receipt of $100. Net is gain of $70 ($120 - $50)

What if B is a Non-Resident for New Jersey purposes?

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Debt Tax Basis / Distributions

LLC/Partnership

A received P and has a basis of $30 in P. There is no deemed sale income. The basis shifts from the basis the LLC had in P ($60) to the lower outside basis that A has in his LLC ownership. A basis loss of $30.

If A then sells P for $100 he will have a gain of $70.

If B then sells Q he has a gain of $100. This increases his outside basis to $130. On liquidation he receives $100 and has a loss of $30. B net gain is $70.

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Special Rules / Exceptions

1. Marketable securities are treated as money except for investment companies or distributions to the contributor.
2. Mixing bowl rules – Section 737 and 704(c)(1)(B); 7-year rule
3. Disguised Sales – Section 707(a)(2)
4. Disproportionate distributions of ordinary income property – Section 751(b)

Qualified Non-Recourse Financing (QNRF)

Basic Rule – QNRF will create at risk amount for losses

In S Corporation the entity QNRF does not create outside tax basis

In Partnership the QNRF creates tax basis and at risk amount

You need tax basis and at risk amount to deduct losses

Ownership Rules

S Corporation
- one class of stock
- eligible entities / trusts
- non-resident aliens

Partnership or LLC
- no limitations

Flexibility for Estate Planning and structuring equity and voting rights interests

Outside Basis

Basic Rule:

A. Upon contribution of an asset to the entity, the owner has an outside basis in the ownership equal to the basis she had in the asset.
B. Basis is adjusted by distributions, income allocations and loss allocations.
C. What can cause outside tax basis to be negative?

Outside Basis: Aggregation Rules

- All interests in a partnership are aggregated to determine the basis per percent of ownership

- S Corporation shares have a separate basis with adjustments done on a per share methodology with a spillover rule.

- Holding periods?
  - additional contributions to a partnership (cash or other)

Scenario 12:

- A owns a ten percent partnership interest with a basis of $100
- A buys another ten percent partnership interest for $200
- A owns twenty percent with each percent having a basis of $15

- If it was S Corporation stock then separate basis per share – if each share was one percent then $10/share and $20/share

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Scenario 13 - Spillover Rule:

- A owns 1 share of 10 outstanding with a basis of $30 for the entire year
- A buys one share from another shareholder for $25 on July 2
- Corporation has a loss of $365 or $1/day is allocated per share
- $36.50 loss to A for per initial share
- $18.50 loss to A for new share

- What happens with the $6.50 in excess of basis of the initial share?

Basis Adjustment (death)

- A dies owning 40% of Entity with business worth $4.0M and assets with a tax basis of $1.0M
- Basis is fair market value at death
- S Corporation Stock / LLC ownership
- Sections 743 and 754
- Partnership election not partner election
- The tax basis of each asset is adjusted – this includes intangible assets
- I have seen negative capital of millions go to positive capital of millions

Basis Adjustment

- On balance sheet / Off balance sheet
- Adjusted capital on Schedule L / Not adjusted on Schedule L
- Report increased depreciation on K-1 / Report increased depreciation on Schedule K-1
- Make the election transparent / Make it difficult on the reviewer of Tax Return

Sale of Ownership Interest

Basic Rule:

- Sale of stock ownership in S Corporation is capital gain
- Sale of ownership in a Partnership to a third party is capital gain (Section 741) subject to the effect of Section 751
- Terminate the Partnership tax year under Section 708
- If you sell stock in cash basis S Corporation that has receivables does the hot asset rule apply?

Entity Purchase of Ownership Interest

- S Corporation has the same capital gain treatment with additional consequences if assets in kind used
- Partnership purchase is a liquidation under Section 736
- Section 708?
- Withdrawing partner status as a partner?
- How do you report a series of liquidating payments to the "former" partner?
- Basis step up inside the Partnership – Section 734 and Section 754

Entity Purchase by Partnership

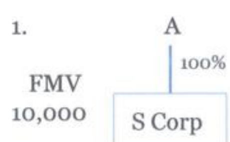
- Section 736(a) – ordinary income = share of income; guaranteed payment
- Section 736(b) – payment for property
- Goodwill – is this property?
- Guaranteed Payments

Cancellation of Debt Income

- Gross income does not include any discharge of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent.
- Who is the taxpayer for purposes of measuring insolvency?
- Entity debt of $1.0M is cancelled while the entity is clearly insolvent but all or some of its owners are not insolvent.

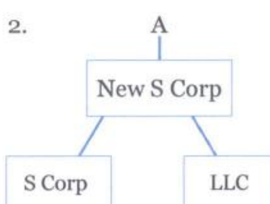
S Corporation Restructure

1.



B wants to buy 50% ownership of S Corporation but want to get depreciation and amortization tax benefits AND want to keep the same Tax ID number

2.

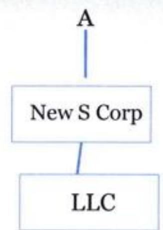


A forms New S Corp and contributes his S Corp stock to New S Corp
- S Corp Election
- QSS Election
-So S Corp becomes QSS (disregarded)

3. New S Corp forms a wholly owned LLC (disregarded)

S Corporation Restructure

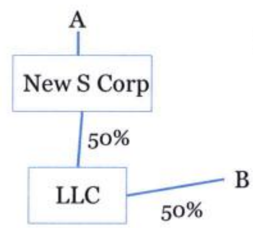
4.



Convert S Corp to an LLC by Conversion or Merger

Tax effect of changing corporation to non corporate entity – asset distributions discussed earlier triggers gain at corporate level

5.



Sell 50% ownership in LLC to B

B's Tax Benefits

- B treated as Purchasing 50% of each asset
- B gets cost basis in assets
- B can depreciate/amortize the new cost basis
- What if S Corp was owned by A and C (more than 1 person) before the restructure

Tax ID Preservation

- Must get IRS to allow LLC to use S Corp Tax ID as business successor
- S Corp must be terminated under State law