



# Dealing with Appreciated Real Estate Inside of a C Corporation

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I. Background.

In the past, many advisers recommended the use of corporations taxed under Subchapter C of the Code<sup>1</sup> ("C Corporations") to own real estate and avoided the use of flow through entities, such as partnerships and Subchapter S Corporations, to own that property. The use of C Corporations to hold real estate has resulted in significant value being locked up inside of C Corporations. The problem today is how to unlock that value for the shareholders at the least tax cost. The recent decreases in real estate values may present some unique planning opportunities.

II. Base Case.

A. For purposes of this outline, we will deal with a C Corporation, Whatsup, Inc., that owns real estate and related personal property. Whatsup, Inc. was formed by Father and Mother on January 1, 1990 with an aggregate contribution of \$100,000 in cash. The corporation then used that cash and \$300,000 in debt to acquire land, a building and furniture, fixtures and equipment ("FF and E"). The assets acquired for a total consideration of \$400,000 were:

1.	Land:	\$300,000
2.	Building (Code §1250):	95,000
3.	FF and E (Code §1245):	<u>5,000</u>
	Total	<u>\$400,000</u>

Assume that the debt has been repaid. Also assume that Father and Mother have given 10% of the shares to each of Son and Daughter.

B. Over the years, Whatsup, Inc. has taken the following depreciation on its assets:

1.	Building:	\$50,000
2.	FF and E:	<u>5,000</u>
	Total	<u>\$55,000</u>

C. As of October 1, 2009, the adjusted basis of the assets in Whatsup are:

1.	Land:	\$300,000
2.	Building:	45,000
3.	FF and E:	<u>\$ 0</u>
	Total	<u>\$345,000</u>

D. Today, the assets of Whatsup generate \$200,000 of cash flow after all operating expenses, but before income taxes.

E. As of October 1, 2009, the fair market value of Whatsup's assets are:

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<sup>1</sup> All references to the Code are to the Internal Revenue Code of 1986, as amended.

1.	Land:	\$4,000,000
2.	Building:	\$ 490,000
3.	FF and E:	\$ 10,000
	Total	<u>\$4,500,000</u>

F. Whatsup has 1,000 shares of common stock outstanding which are owned as follows:

	<u>Shareholder</u>	<u># of Shares</u>	<u>Tax Basis</u>
1.	Father	400 shares	\$ 40,000
2.	Mother	400 shares	\$ 40,000
3.	Daughter	100 shares	\$ 10,000
4.	Son	<u>100 shares</u>	<u>\$ 10,000</u>
	Total	<u>1,000 shares</u>	<u>\$100,000</u>

III. Tax Rules for a C Corporation.

A. General.

1. When Father and Mother established Whatsup, Inc., the cost basis for their shares was \$100,000. Code § 358(a)(1). When Mother and Father gave shares to Son and Daughter over the ensuing years, Mother's and Father's cost basis in those shares carried over to Son and Daughter. Code § 1015(a).

2. Whatsup, Inc. has a cost basis in its assets which was initially established by its purchase price for the land, building and personal property. Code § 1012. This cost basis has been adjusted over the years as depreciation was taken on the Building and the FF and E.

3. The income of Whatsup, Inc. is taxed to the corporation when earned. Code § 11. If Whatsup, Inc. distributes part of its earnings to its shareholders, then those shareholders may owe an income tax on the distribution. Code § 301(c). This system of taxation for a C Corporation and its shareholders, where the corporation is taxed on its earnings and distributions to shareholders of those after-tax earnings are taxed a second time, is often referred to as a "double tax" system.

(a) For purposes of this discussion, we assume that all of the income of Whatsup, Inc. will be taxed at the current top marginal rate applicable to C Corporations of 35%. Code § 11(b).

(b) We also assume that any dividends will be "qualified dividends" and taxed at the favorable long-term capital gains rate (currently 15%). Code § 1(h)(11). All indications are that the favorable capital gains rate will increase to 20% as of January 1, 2011, if not earlier.

(c) For purposes of our analysis, we will ignore state and local taxes.

B. Taxation of Distributions from a C Corporation.

1. General. In general, distributions from a C Corporation may be taxed if they are: (i) distributions under Code § 301 (ii) distributions in redemption of stock, or (iii) distributions in complete liquidation of the corporation. The amount of a distribution from a corporation equals the amount of any money the shareholder receives, plus the fair market value of any property distributed,

reduced by any liabilities the shareholder assumes as part of the distribution. Code §§ 301(b) and 331(a).

(a) Cash Distribution. The consequences of a cash distribution to the corporation are fairly straightforward: the corporation incurs no corporate level tax on the distribution of cash, and the amount of the distribution to the shareholder is the amount of the cash distributed.

(b) Distribution of Property in Kind. If a corporation distributes appreciated property, it must recognize gain to the extent the property's fair market value on the distribution date exceeds the corporation's basis in the property. Code § 311(b). The amount of the distribution to the shareholders is the property's fair market value on the distribution date.

2. Distributions under Code § 301. A distribution is taxed under Code § 301 if it is classified as a "dividend."

(a) Under Code § 316, a "dividend" means any distribution of property made by a corporation to its shareholders: (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits for the current taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of earnings and profits at the time the distribution was made.

(b) There is no statutory or regulatory definition for the term "earnings and profits." In defining earnings and profits, the courts have held that the term represents the net increase in the amount of assets of the corporation over and above the amount of its assets received from its stockholders as contributions to capital. Luckman v. Commissioner, 418 F.2d 381, 383 (7th Cir. 1969).

(c) Under Code § 301, there are ordering rules for determining how a distribution is taxed:

(i) First Portion: Dividend. That portion of the distribution which is a dividend, as defined in Code § 316 (out of the corporation's earnings and profits), is included in a shareholder's gross income.

(ii) Second Portion: Amount applied against basis. That portion of the distribution which is not a dividend is applied against and reduces the adjusted basis of a shareholder's stock. Thus, this second portion of the distribution is not taxed.

(iii) Third Portion: Amount in excess of basis. In general, that portion of the distribution which is not a dividend and exceeds the adjusted basis of the shareholder's stock is treated as gain from the sale or exchange of property.

**Example 1:** Assume that Whatsup has accumulated earnings and profits of \$750,000 and distributes \$200,000 in cash to its shareholders. The shareholders, as a group, recognize dividend income of \$200,000 on this distribution.

**Example 2:** Assume that Whatsup has accumulated earnings and profits of \$750,000, no earnings and profits for the current year and distributes \$1,000,000 in cash to its shareholders. As a group, the shareholders have a basis of \$100,000 for their stock. The shareholders, as a group, recognize:

Dividend income of \$750,000;  
Return of Basis of \$100,000; and  
Capital gain of \$150,000.

3. Redemption/Partial Liquidation. If a corporation redeems its stock (within the meaning of Code § 317(b)), and the redemption qualifies under one of the tests of Code § 302(b)(1) through (4) or Code § 303, then the redemption is treated as a distribution in part or full payment in exchange for the stock. In other words, the recipient shareholder generally receives capital gain treatment.

(a) If a transaction does not qualify under Code § 302(b)(1) through (4) or Code § 303, then the redemption is treated as a distribution of property to which Code § 301 applies. Code § 302(d).

(i) The difference between dividend and capital gain treatment currently is muted by the identical tax rates that apply. If the law changes back to taxing dividends as ordinary income, then the difference will become important.

(ii) Even now, dividend treatment means the selling shareholder receives no benefit from his or her cost basis in the stock.

(iii) The difference in treatment also is critical if the stock is being purchased for a note. If the redemption is treated as a dividend, 100% of the proceeds are taxed in the year of the redemption, regardless of how the payments are structured or when they are received.

(b) Under Code § 302(b), a purchase of stock by a C Corporation will qualify for exchange treatment only if the redemption: (i) is "substantially disproportionate," (ii) results in a "complete termination" of the shareholder's interest, (iii) is not "essentially equivalent to a dividend" in light of all relevant facts and circumstances, or (iv) is a partial liquidation.

(i) Substantially Disproportionate Redemptions. A redemption will be considered substantially disproportionate under Code § 302(b)(2) if: (A) the individual has reduced his percentage ownership of the voting stock of the corporation by more than 20 percent; (B) the individual has reduced his percentage ownership of the common stock of the corporation by more than 20 percent; and (iii) the individual owns less than 50 percent of the voting power of the corporation after the redemption.

**Example 3:** Unrelated individuals, Father and Stranger, each own 50 of the 100 outstanding shares of Whatsup, Inc. common stock, and no other stock is outstanding. The corporation distributes \$30,000 to Stranger in exchange for 20 of his shares.

This redemption qualifies as an exchange because Stranger reduced his ownership in the common (and voting) stock by more than 20 percent. He owned 50 percent of the stock before the redemption (50 shares out of 100 shares) and 37.5 percent of the stock after the redemption (30 shares out of 80 shares). Since his 37.5 percent ownership is only 75 percent of his previous 50 percent ownership, he has had a reduction of over 20 percent, as is required.

Since after the redemption Stranger owns less than 50 percent of the voting stock, the redemption is substantially disproportionate.

(A) These required reductions in ownership would often be easy to meet, were it not for the attribution rules that are applied in determining ownership of a corporation under Code § 318. The attribution rules provide that an individual is considered to own not only the stock he owns outright but also the stock owned by certain related parties. Specifically, the following stock will be attributed to the individual: (i) stock owned by members of his immediate family (spouse, children, grandchildren, and parents); (ii) stock owned by certain entities (estates or trusts in which he is a beneficiary, partnerships in which he is a partner, and corporations in which he is a 50 percent shareholder); and (iii) stock that he has an option to acquire. Code § 318(a).

(B) In addition, entities are considered to own stock owned by their beneficiaries, partners, and shareholders (if the shareholder is a 50 percent owner of the corporation). Code § 318(a)(3).

(C) These attribution rules can be applied more than once and become very complicated. Code § 318(a)(5). Redemptions in family-owned corporations, therefore, often do not qualify under the substantially disproportionate rules.

**Example 4:** Father and Son each own 50 of the 100 outstanding shares of Whatsup, Inc. common stock, and no other stock is outstanding. The corporation distributes \$30,000 to Son in exchange for 20 of his shares.

This redemption will not qualify as an exchange because of the attribution rules. Although Son sold shares, his ownership in the common (and voting) stock is unchanged because of the attribution rules. Son owned 100 percent of the stock before the redemption (50 of the 100 shares personally and 50 of the 100 shares through attribution from Father) and 100 percent of the stock after the sale (30 of the 80 shares personally and 50 of the 80 shares through attribution from Father). Thus, Son has experienced no reduction in ownership due to the attribution rules.

(ii) Complete Terminations. To enable redemptions in family-held corporations to qualify for exchange treatment, Code § 302(b)(3) was enacted. Section 302(b)(3) extends exchange treatment to a redemption in which the entire interest of a shareholder in the corporation (as shareholder, employee, director, or any other relationship except that of creditor) is terminated after the redemption. (Since the individual is entitled to retain his interest in the corporation as a creditor, the corporation is able to pay part of the redemption proceeds in the form of a note).

(A) The individual must not only terminate his entire interest in the corporation, but must also sign an agreement whereby he recognizes that exchange treatment will subsequently be denied if he reacquires any interest in a prohibited capacity within ten years. Code § 302(c). In addition, special problems arise if the party whose shares are being redeemed received stock from or transferred stock to a related party during the ten-year period immediately before the redemption.

(B) If the requirements of § 302(b)(3) are met, the family attribution rules are waived. Code § 302(c)(2). In this case, the individual whose stock is redeemed will not be considered to own stock that is owned by his spouse, children, grandchildren, or parents.

(C) This type of redemption is useful in providing liquidity to an individual; however, it is much less useful if an estate or trust is to be the entity whose shares are redeemed. This is because only *family* attribution is waived, not the attribution to the estate or trust of stock owned by a beneficiary. Thus, if any beneficiary of the estate continues to own stock in the closely held corporation (as would often be the case in a family situation), the redemption will not qualify for exchange treatment under this provision.

(D) On the other hand, a complete termination of an estate or trust may be effective if a family member of a beneficiary (rather than the beneficiary himself) continues to own stock in the corporation. Under applicable law, an estate or trust may waive family attribution from a family member of a beneficiary to the beneficiary if certain requirements are met. Code § 302(c)(2)(C). Specifically, both the estate or trust and the beneficiary must meet all the requirements for waiver, discussed previously. The beneficiary must also agree to be jointly and severally liable for any additional tax assessed in the event he acquires any interest in the company in a prohibited capacity within ten years.

(E) The applicable legislative history emphasizes that this provision does not apply to waiver of attribution from a beneficiary to the estate or trust. Thus, in planning for the estate, one should assume that no complete termination of interest can be effected by an estate or trust if any of its beneficiaries continue to own stock in the corporation.

**Example 5:** Whatsup, Inc. redeems all the stock held in a trust of which Son and his descendants are exclusive beneficiaries. Father and Mother own all the remaining stock of Whatsup. All of the Father's and Mother's shares are attributed to Son under the family attribution rules, and all the shares deemed constructively owned by Son are, in turn, attributed to the trust under the entity attribution rules. If both the trustee and Son sign the required waiver agreement and Son agrees to be personally liable for any tax deficiency resulting from a prohibited reacquisition, then the family attribution rules may be waived and Whatsup's redemption from the trust will be a complete termination of the trust's stock interest. On the other hand, if Son or any of his descendants also directly own shares of stock in Whatsup, those shares will be attributed to the trust under the entity attribution rules for which no waiver is permitted, and the trustee's interest in Whatsup cannot be considered completely terminated.

(iii) Redemption Not Essentially Equivalent to a Dividend. The determination of whether a redemption is not essentially equivalent to a dividend under Code § 302(b)(1) must be made in light of all relevant facts and circumstances. The case law and IRS pronouncements can be difficult to reconcile. This provision will not apply if the redeemed shareholder, directly or by attribution, is deemed to own all of the shares of the corporation. This provision is more readily available if the redeemed shareholder does not control the corporation.

(iv) Redemption in Partial Liquidation. A corporation's purchase of stock held by a shareholder who is not a corporation also qualifies as a redemption. Code § 302(b)(4).

(A) In order to qualify as a partial liquidation, the distribution must not be "essentially equivalent to a dividend" (at the corporate level) and the distributions must be pursuant to a plan. Code § 302(e)(1).

(B) Most qualifying distributions under this provision involve distributions due to contracting the business of the corporation. Code § 302(e)(2).

(v) Redemption to Pay Estate Taxes. Since the attribution rules in determining stock ownership frequently make it impossible to qualify redemptions of family-held corporations for exchange treatment (as opposed to dividend treatment), and since, in these settings, redemptions are often necessary to pay death taxes attributable to stock ownership in closely held corporations, Congress enacted Code § 303 to reduce the tax burden of redeeming stock at death.

(A) Section 303 permits exchange treatment for a redemption if more than 35 percent of the decedent's gross estate, as adjusted (gross estate less total allowable deductions for funeral and administration expenses, debts, and losses), consists of the stock of a corporation. Code § 303(b)(2)(A).

(B) If a decedent owned stock in more than one corporation, and if he owned at least 20 percent of the aggregate value of all of the outstanding shares (of all classes) of each such corporation, the stock interests can be aggregated to reach the 35 percent level. Code § 303(b)(2)(B).

(C) Stock deemed to be owned by attribution cannot be included to reach the necessary 20 percent.

(D) If the alternate valuation date is selected, values as of that date are used for determining whether the requirements of this provision are satisfied. However, an executor cannot combine multiple corporations by a tax-free reorganization after the date of death to meet the 35 percent requirement, even if he chooses the alternate valuation date for the estate. Rev. Rul. 69-594, 1969-2 C.B. 44.

**Example 6:** An individual owned 15 percent of three closely held corporations. His stock holdings in each corporation constituted 20 percent of the value of his estate. Two months after his death, the three corporations were merged so that the estate then owned 15 percent of the stock of one much larger corporation, which now make up 60 percent of the estate. Even if the executor chooses the alternate valuation date (at which time the single stock interest constituted 60 percent of the estate), a redemption under Code § 303 would not be available since, at the time of the decedent's death, the requisite stock ownership did not exist.

(E) Section 303 limits the amount of stock that is redeemable to the aggregate of (i) all federal and state death taxes imposed because of the decedent's death and (ii) the amount of funeral and administration expenses allowable as deductions to the estate. Code § 303(a). Since the provision refers to allowable expenses, an executor who elects to take certain administration expenses as income tax deductions, rather than estate tax deductions, still may include them when determining the amount of stock that can be redeemed under this provision.

(F) It is not necessary to actually use the money from the redemption to pay the taxes and expenses. In fact, property other than cash may be distributed by the corporation when it redeems the shares. Of course, a corporation will recognize gain if it distributes appreciated property. Code § 311.

(G) A note may also be used if the corporation is short of cash and other property is not available, as long as the note is a true debt instrument. If this is done, however, the parties should be careful to structure the terms of the note so as not to run afoul of the original issue discount rules. See Code §§ 483, 1271-1274.

(H) Any amount redeemed in excess of the taxes and expenses will generally be considered a dividend to the estate, unless it qualifies for exchange treatment under one of the other provisions of the Code. A redemption under Code § 303 must normally occur within 3 years and 90 days from the date when the federal estate tax return is filed. If a deferral of estate taxes is elected under Code § 6166, a redemption will qualify if it is made on or before the due date of the last installment. However, any redemptions made later than 4 years after the decedent's death are limited to (i) aggregate death taxes and administration expenses remaining unpaid just before the redemption, or (ii) the total of the taxes and administration expenses actually paid during the 1-year period beginning on the date of the redemption, whichever is less (so that that total will then, in effect, be set by the amount of the redemption). Code § 303(b)(4).

4. Liquidation of Corporation. Unlike non-liquidating cash or property distributions, the liquidation of a corporation is not treated as a dividend distribution to the extent of corporate earnings and profits. Instead, Code § 331(a) requires that liquidating distributions be treated as full payment in exchange for the shareholders' stock.

(a) In a liquidation, a shareholder is treated as if he sold his stock to the corporation and, therefore, must recognize gain or loss (generally capital gain or loss) on the difference between the amount realized and his adjusted basis in the stock.

(i) If the shareholder assumes liabilities (or takes the distributed property subject to liabilities) of the liquidating corporation, the amount of the liabilities reduces the shareholder's amount realized.

(ii) The shareholder takes a basis in the property equal to the fair market value of the property at the time of distribution.

(b) The treatment of a liquidation from the corporation's perspective depends upon whether cash or other property is distributed.

(i) In the case of cash distributions, the liquidating corporation incurs no income tax consequences, other than a reduction of its earnings and profits.

(ii) In the case of property distributions, the corporation recognizes gain or loss as if the corporation sold the property to the shareholder at its fair market value. Thus, in general, the corporation recognizes gain or loss equal to the difference between the fair market value of the distributed property and its adjusted basis at the time of distribution. Code § 336(a).

(iii) If assets are distributed in liquidation subject to liabilities, the fair market value of the assets is not less than the face amount of the liabilities. Code § 336(b).

**Example 7:** Whatsup distributes all of its assets to its shareholders in complete liquidation. Whatsup recognizes gain of \$4,155,000 (the difference between the fair market value of the assets (\$4,500,000) and Whatsup's adjusted basis therein (\$345,000)). Whatsup incurs a tax liability of \$1,454,250 ( $\$4,155,000 \times 35\%$ ) and, as a result, distributes net assets having a fair market value of \$3,045,750 to its shareholders.

The shareholders, as a group, recognize capital gain of \$2,945,750 (\$3,045,750 net fair market value less \$100,000 basis in their shares) and pay tax at long-term capital gains rates since they have held the Whatsup shares for more than one year.

C. Sale of Assets by a C Corporation. If a C Corporation sells an asset, it will recognize gain or loss equal to the difference between its cost basis in the asset and the fair market value of the consideration received. Code § 1001.

D. Sales of Stock by a Shareholder. A shareholder could sell his or her shares to another shareholder or to a third party. On a sale of shares, the shareholder would recognize gain equal to the difference between the basis for those shares and the fair market value of the consideration received. Code § 1001.

E. Real Estate Trapped in the C Corporation. With these rules in mind, what can the shareholders of Whatsup, Inc. do to get the value of their investment out of the corporation at the least tax cost? Again, the goal is to get the value into the hands of the shareholders. The alternatives include:

1. A sale of the assets by Whatsup, Inc. followed by a distribution of the net proceeds.
2. A distribution of the assets by Whatsup, Inc. to the shareholders, followed by a sale of the property by the shareholders.
3. A liquidation of Whatsup, Inc. followed by a sale of assets by the shareholders.
4. Conversion of the corporation to a partnership or limited liability company.
5. An election to be taxed under Subchapter S of the Code.

6. Contribution of assets to a partnership or LLC.

IV. Sale of Assets and Liquidation.

A. General.

1. The first option available to Whatsup, Inc. is to sell its assets and then distribute the net proceeds to its shareholders. Whatsup will recognize gain on the sale of its assets and the shareholders will recognize gain upon the liquidation of the corporation.

**Example 8:** Whatsup sells all of its assets to Whosit Corp. for \$4,500,000.

Whatsup recognizes gain of \$4,155,000 (the difference between the fair market value of its assets of \$4,500,000 and its adjusted basis in the assets of \$345,000). Whatsup incurs a tax liability of \$1,454,250 ( $\$4,155,000 \times 35\%$ ) on the sale of the assets.

Whatsup then liquidates and distributes the net cash received to its shareholders. Whatsup will make a net distribution of \$3,045,750 to its shareholders. The shareholders, as a group, recognize capital gain of \$2,945,750 ( $\$3,045,750$  less their \$100,000 basis in their shares).

Assuming the shareholders have held the Whatsup shares for more than one year, they will pay a capital gains tax of \$441,862.50 ( $\$2,945,750$  times 15%).

The shareholders keep \$2,603,887.50, after tax (about 58% of the value of the assets of the corporation). The Internal Revenue Service receives \$1,896,112.50 (about 42% of the value of the assets of the corporation).

**Example 9:** Assume, however, that the capitalization rates used to value real estate have changed significantly so that the building and land are valued at a 50% discount. The building has a value of \$245,000 instead of \$490,000 and the land has a value of \$2,000,000 instead of \$4,000,000. Assume the FF and E still has a value of \$10,000.

If Whatsup sells all of its assets for \$2,255,000, then its gain on sale is \$1,910,000 ( $\$2,255,000$  less \$345,000) and the tax is \$668,500 ( $\$1,910,000$  times 35%).

If Whatsup then liquidates and distributes the cash, only \$1,586,500 is received by the shareholders ( $\$2,255,000$  less \$668,500). The shareholders recognize a capital gain of \$1,486,500 ( $\$1,586,500$  less \$100,000) and pay a tax of \$222,975 ( $\$1,486,500$  times 15%).

In this instance, the family retains only \$1,363,525 ( $\$1,586,500$  less \$222,975).

2. Under Code § 1239, in the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor will be treated as ordinary income if, in the hands of the transferee, such property is of a character which is subject to the allowance for depreciation provided in Code § 167. This presents more of an issue for an S corporation since a C corporation's ordinary income and capital gains are taxed at the same rates.

Code § 1239 applies only to the portion of the gain attributable to the depreciable property and not, for example, to the gain attributable to the land. See Rev. Rul. 72-172, 1972-1 C.B. 265.

B. Possible 1031 exchange. It could be possible for Whatsup to use Code § 1031 to defer the recognition of gain if certain qualifying property is exchanged solely for "like-kind" property. The problem with this approach is that the shareholders do not get access to assets if a Code § 1031 exchange is done since the exchange property remains in the corporation. Additionally, if the exchange property is distributed to the shareholders, the corporation will be treated as if it sold the property.

C. Installment Sale The assets of Whatsup could be sold on an installment basis which would defer when the capital gains tax must be paid by the corporation.

1. General. In order to qualify for installment reporting, at least one payment must be received by the seller after the close of the taxable year of the sale.

(a) If the sale qualifies for installment reporting, the seller computes the percentage of the total purchase price that is represented by the taxable gain. The seller then reports that percentage of the payments received in each year as income or gain on the seller's income tax return.

(b) The installment method allows the seller to defer payment of the tax on the purchase price until payments are received.

(c) If the purchase price paid is greater than \$5 million, or if the seller holds more than \$5 million in installment obligations, the seller will be required to pay interest on the deferred tax under Code § 453A(c).

(d) Installment reporting is not available with respect to the portion of the purchase price that represents depreciation recapture. Code § 453(i). The depreciation recapture must be recognized by the seller in full in the year of the sale regardless of how much, if any, of the purchase price is received in the year of sale.

(e) One option may be to sell the assets and then make a subchapter S election in order to avoid a double tax. As discussed later in this outline, the double tax treatment still remains for S Corporations that have converted from C Corporations (called the "Built-In Gains Tax"). A sale of an asset before or during the 10-year Built-In Gains Tax period is subject to the Built-In Gains Tax as installment payments are received either during or after the 10-year period. Treas. Reg. § 1.1374-4(h).

2. Sale to a Third Party. The problem with the installment sale by the corporation to a third party is that the receipt of the proceeds by Whatsup is deferred and the ability to get value into the hands of the shareholders is deferred. There is also the risk of dealing with a third party as a creditor. Finally, if the value of the property is temporarily depressed, any benefit that arises when the property recovers its value is lost if the property is sold to a third party.

3. Sale to Shareholders. Subject to the special recapture rules noted above, a corporation may sell assets to one or more of its shareholders using the installment method. Doing so effectively "freezes" the value of the asset in the hands of the corporation and passes appreciation to the shareholders.

(a) If the shareholders buy the assets from the corporation on an installment basis, they may take advantage of today's low market values for the assets and low interest rate environment. For September 2009, the applicable federal rates for a loan with annual payments of interest are:

	<u>September 2009 Rate</u>
Short-Term	.84%
Mid-Term	2.87%
Long-Term	4.38%

(b) If the shareholders purchase the assets, then gain will be recognized to the extent of recapture, but most will be deferred. The buyers can dispose of the property purchased on an installment basis after two years without adverse tax consequences. Code § 453(e).

**Example 10:** Given the change in capitalization rates used to value real estate, assume the land is valued at \$2,000,000, the building at \$245,000 and FF and E at \$10,000. In September 2009, Father, Mother, Son and Daughter purchase the land, building and FF and E from Whatsup, Inc. for \$2,255,000. The purchase price is paid with a note for \$2,255,000. The note provides for interest at the applicable federal rate of 4.38% with a balloon principal payment in 50 years.

Father, Mother, Son and Daughter have a \$2,255,000 cost basis in the assets. In November 2011, they sell the assets for \$4,500,000 in cash. Their cost basis for the assets is \$2,255,000 so they have a capital gain of \$2,245,000 (\$4,500,000 less \$2,255,000) and pay a tax of \$336,750 (\$2,245,000 times 15%). (Ignoring any recapture tax and any depreciation in the intervening period). The family has \$4,163,250 after tax (\$4,500,000 less \$336,750). The annual interest costs on the loan are \$98,769 (\$2,255,000 times 4.38%).

At this point, Whatsup has a single asset (the note from the family for \$2,255,000) and has deferred the payment of \$668,500 of tax (\$1,910,000 of gain taxed at a 35% rate). The family has \$4,163,250 in cash, owns stock worth \$1,586,500 (\$2,255,000 reduced by the deferred tax of \$668,500) with a basis of \$100,000, and owes Whatsup \$2,255,000.

(c) What is the exit strategy for the shareholders who have acquired the assets from Whatsup?

(i) The shareholders could use \$2,255,000 of their cash to repay the loan and retain \$1,908,250 (\$4,163,250 less \$2,255,000). Repayment would cause the tax to be paid by Whatsup (\$668,500). After paying the income tax, Whatsup has \$1,586,500 (\$2,255,000 less \$668,500). If the corporation then liquidates, the shareholders would owe a capital gains tax of \$222,975 (\$1,586,500 less \$100,000 times 15%), and keep \$1,363,525 (\$1,586,500 less \$222,975). Thus, at the end of the day, the shareholders keep \$3,271,775 (\$1,908,250 plus \$1,363,525). This is a significantly better result than selling to the assets to a third party in a "down" market (net to shareholders of \$1,385,625) or allowing the appreciation in the property to occur inside of Whatsup (net to shareholders of \$2,603,875).

(ii) If the shareholders do not repay the loan, there is a risk that the amount of the debt could be treated as ordinary income from debt forgiveness if the debt is cancelled or as a constructive dividend. See Walker v. Tomlinson 210 F. Supp. 401 (1962).

(iii) Does the family repay \$682,500 of the note to make sure Whatsup has sufficient cash to cover the taxes? This would trigger part of the deferred tax.

(iv) Does the family contribute the shares, subject to the notes, to charity?

V. Distributions of Assets by a C Corporation followed by Shareholder Sale.

A. A corporation may distribute either cash or other property to its shareholders with respect to its stock.

**Example 11:** Ignoring whether a significant distribution of assets is a "deemed" liquidation, assume Whatsup distributes the land and building to the shareholders as a dividend. Given the changes in capitalization rates used to value real estate, the land is valued at \$2,000,000 and the building is valued at \$245,000.

Upon distribution, Whatsup recognizes gain in an amount equal to the difference between (i) the fair market value of the land and building (\$2,245,000), and (ii) the corporation's basis in these assets (\$345,000), for a total gain of \$1,900,000. A portion of the gain may be Code § 1250 recapture. Whatsup owes a tax of \$665,000 (\$1,900,000 times 35%). Whatsup retains the FF and E.

Assume Whatsup borrows the cash to pay the tax and distributes the assets to the shareholders subject to that debt. The shareholders receive a net distribution of \$1,580,000 (\$2,245,000 less \$665,000). Assuming Whatsup has \$750,000 of earnings and profits from prior years (and its earnings and profits are increased by \$1,900,000 for the current year due to the recognition of income on the distribution of assets), the entire distribution is taxed as a dividend.

The shareholders have received a dividend and owe a tax of \$237,000 (\$1,580,000 times 15%). After tax, the shareholders own the properties worth \$2,245,000 subject to \$902,000 in debt (\$665,000 plus \$237,000). Their cost basis in the land and building is \$2,245,000. Code § 301(d); Ford v. U.S., 311 F.2d 951 (Ct. Cl. 1963). If they later sell the assets for \$4,490,000, they will have a capital gain of \$2,245,000 (\$4,490,000 less \$2,245,000) and pay a capital gains tax of \$336,750 (\$2,245,000 times 15%). The shareholders keep \$3,251,250 (\$4,490,000 less \$902,000 less \$336,750). They still own the stock in Whatsup (which has the FF and E worth \$10,000).

VI. Liquidation of Corporation followed by Shareholder Sale of Assets

A. Under Code § 336, which applies to liquidating distributions, gain or loss is recognized to a liquidating corporation on the distribution of property in complete liquidation. Additionally, the shareholders are treated as if they received the assets in exchange for their shares.

**Example 12:** Whatsup distributes all of its assets to its shareholders in complete liquidation while the value of the real estate is depressed (land valued at \$2,000,000, building valued at \$245,000 and FF and E valued at \$10,000).

Whatsup recognizes gain of \$1,910,000 which is the difference between the fair market value of the assets (\$2,255,000) and Whatsup's adjusted basis in the assets (\$345,000). Whatsup incurs a tax liability of \$668,500 (\$1,910,000 times 35%). Whatsup borrows \$668,500 to pay this tax.

Whatsup makes a net distribution of \$1,586,500 to its shareholders (\$2,255,000 less \$668,500). The shareholders, as a group, recognize capital gain of \$1,486,500 (\$1,586,500 net fair market value less \$100,000 basis in their shares). The shareholders' bases in the distributed assets equal the fair market value of those assets (\$2,255,000), unreduced by the debt. Code § 334(a); Ford v. U.S., 311 F.2d 951 (Ct. Cl. 1963). Assuming they have held the Whatsup shares for more than one year, they pay a capital gains tax of \$222,975 (\$1,486,500 times 15%). The shareholders borrow \$222,975 to pay the tax.

The shareholders then sell the assets to a third party for \$4,500,000. Their basis in the property is \$2,255,000. Upon sale, they recognize a gain of \$2,245,000 (\$4,500,000 less \$2,255,000) and owe a capital gains tax of \$336,750 (\$2,245,000 times 15%). After tax, the shareholders retain \$4,163,250 (\$4,500,000 less \$336,750), after tax. They use the proceeds to repay the two loans totaling \$891,475 (\$668,500 plus \$222,975) and keep \$3,271,775 (\$4,163,250 less \$891,475).

VII. Conversion to Partnership or LLC<sup>2</sup>.

A. Another option to consider is the conversion of Whatsup from a C Corporation to a flow through entity, such as a partnership or LLC (taxed as a partnership). This would be done so that the double tax system is avoided.

1. The conversion of a C Corporation to an LLC could occur in one of numerous ways:

(a) The corporation contributes all of its assets to the LLC in return for LLC member interests, followed by a liquidation of the corporation, under which the corporation distributes the member interests to its shareholders in exchange for their stock ("assets over" approach).

(b) The corporation distributes its assets to its shareholders in complete liquidation in exchange for their stock, and then the shareholders contribute the assets to the LLC in return for the member interests of the LLC (the "assets up" approach). A "formless" conversion under the Hawaii Business Corporation Act that allows the physical transfer of assets to be entirely avoided by a mere conversion from corporate status to partnership status is a variation of the "assets up" approach.

(c) The shareholders of the corporation contribute their corporate stock to the LLC, making the LLC the sole shareholder of the corporation, and then the corporation liquidates into the LLC.

2. Under Code §§ 331 and 336, all of these approaches cause income recognition for the shareholders and C Corporation.

(a) Tax treatment of the "assets over" approach:

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<sup>2</sup> For purposes of this outline, the term "partnership" refers to any business form taxable as a partnership under the Code. This includes limited partnerships and limited liability companies ("LLCs"). Either form could be used in this case. See, Treas. Reg. § 301.7701-3(g)(1)(ii); Cf. Rev. Rul. 2001-59, 2001-29 IRB 1050.

(i) In general, no gain or loss will result to the LLC or to the C Corporation upon the contribution of assets by the corporation to the LLC in exchange for member interests of the LLC. Code § 721.

(ii) When the corporation distributes the LLC member interests to its shareholders, the corporation recognizes gain or loss on the distribution of property as if the corporation had sold the property to its shareholders at its fair market value at the time of the distribution. Code § 336. The amount and character of such gain or loss will be determined under Code §§741 and 751.

(iii) The distributions by the corporation to its shareholders in complete liquidation of the corporation are treated as full payment in exchange for the corporation stock within the meaning of Code § 331(a). Gain or loss is recognized by the shareholders equal to the difference between the fair market value of the member interests of the LLC received and their adjusted basis in the stock. The basis in the LLC member interests received by the shareholders will be the fair market value of member interests determined at the time of the distribution. Code § 742.

(iv) The corporation's distribution of the member interests of the LLC to the shareholders will constitute an exchange that will cause the LLC to terminate pursuant to Code § 708(b)(1)(B).

(A) The LLC's termination will result in (i) a deemed distribution of the LLC's assets to a "new" LLC and (ii) the deemed immediate distribution of the member interests of the "new" LLC to the members.

(B) Under Code §§ 721 and 731, no gain or loss will be recognized by the LLC or the shareholders upon the deemed contribution and distribution.

(b) Tax Treatment of the "Assets Up" Approach.

(i) The distribution of the assets by the corporation to its shareholders is treated as a sale of the assets by the corporation in complete liquidation. Code § 336(b).

(ii) The receipt of the assets by the shareholders is treated as the receipt of property in exchange for this stock. Code § 331(a). Thus, the result is a fully taxable transaction.

(iii) When the shareholders subsequently contribute the assets to the LLC, there is no gain or loss recognized on the transfer to the LLC. Code § 721.

(iv) The LLC takes a basis for those assets equal to the shareholders' bases in the assets. Code § 723. The shareholders, in turn, have a basis in their LLC interests equal to their tax basis in the assets contributed to the LLC. Code § 722.

(c) Contribution of Stock.

(i) If the shareholders contribute their stock to an LLC and the corporation liquidates, no tax is incurred by the LLC or by the shareholders at the time of the contribution of the stock to the LLC. Code § 721.

(ii) The LLC takes a basis in the shares equal to the shareholders' bases in that stock. Code § 723.

(iii) The shareholders take a basis in their LLC interests equal to their bases in their shares. Code § 722.

(iv) When the corporation liquidates, it recognizes gain in an amount equal to the difference between the fair market value of its assets and its basis in those assets. Code § 336.

(v) The LLC recognizes gain equal to the difference between the net fair market value of the assets it receives from the corporation and the LLC's basis in the shares. Code § 331.

(vi) The LLC's gain, in turn, flows through to the members and increases their bases in the LLC interests. Code § 705(a)(1).

#### VIII. Conversion to S Corporation.

A. An existing C Corporation can elect to be taxed as an S Corporation. The goal with making the Subchapter S election would be to avoid the double tax regime which impacts C Corporations. In particular, it would be avoiding the 35% tax on the gain on the sale of assets by the C Corporation.

B. The Code specifies six requirements that a corporation must satisfy in order to be classified as an S Corporation (Code § 1362(b)):

1. The corporation must be a domestic corporation or unincorporated association taxed as a corporation for federal income tax purposes.

2. It may have no more than one hundred shareholders (with certain family members being treated as one shareholder).

3. Shareholders must be individuals, estates, certain types of trusts or certain tax-exempt organizations.

4. Shareholders must be citizens or residents of the United States.

5. The corporation must not be an ineligible corporation. Ineligible corporations include insurance companies, corporations electing under Code § 936, and former or current domestic international sales corporations.

6. The corporation may only have one class of stock.

C. To make the S election, the corporation files Form 2553. Treas. Reg. § 1.1362-6(a)(2). All of the S corporation's shareholders must consent to the election in writing.

D. Potential negative tax consequences for an existing C Corporation to make an election to be taxed as an S corporation include:

1. The corporation will be subject to the "built-in gains tax" after it becomes an S corporation. This tax is imposed at the highest corporate rate on unrealized gains on assets existing at the time the election is made if the assets are sold or otherwise disposed of within 10 years. Code § 1374.

(a) For corporations having appreciated inventories, or cash basis corporations with accounts receivable on the effective date of the conversion, a certain amount of built-in gains tax is unavoidable.

(b) This will require a valuation of the assets of the corporation in order to determine the "built-in" gains of each asset at the time of the election.

2. The corporation loses the benefit of any carryovers of losses, deductions, or credits existing when the S corporation election is made, except to the extent they can be used to reduce gains that are subject to the built-in gains tax. Code § 1371(b) and Treas. Reg. § 1.1374-5.

3. If the corporation has accumulated earnings and profits, it will be subject to tax at the highest corporate rates on passive investment income if such income makes up a substantial percentage of its income after the conversion. Code § 1375. Actively managed real estate typically does not produce passive income, but real estate leased on a "triple net" basis may.

4. If the corporation maintains its inventory using the last-in, first-out method (LIFO), it must include a LIFO recapture amount in its income at the time the S corporation election is made. This means that the amount by which the amount of the corporation's inventory computed under the FIFO (first in, first out) method exceeds the amount computed under the LIFO method must be included in the corporation's income even though no cash is generated to pay the tax. Code § 1363(d).

E. If the shareholders can avoid significant sales of corporate assets until the expiration of the 10-year built-in gains period, electing S corporation status is an effective way of dealing with the double tax inherent with having real estate held by a C corporation.

**Example 13:** Effective January 1, 2010, Whatsup elects to be an S corporation for federal income tax purposes. If the corporation's assets are sold after December 31, 2019, the built-in gains tax is avoided.

On January 10, 2020, Whatsup sells all of its assets for \$4,500,000. Assuming the basis of the assets is still \$345,000, Whatsup passes the \$4,155,000 gain out to the shareholders, who pay tax on that gain at 15% (subject to recapture of part of the gain under 1245 and 1250). The shareholders' basis for their shares increases from \$100,000 to \$4,255,000 (due to the gain recognition) and \$245,000 of additional gain is recognized when the corporation liquidates and \$4,500,000 is distributed to the shareholders.

The shareholders recognize total capital gain of \$4,400,000 (\$4,155,000 plus \$245,000) and pay a total of \$660,000 in taxes (\$4,400,000 times 15%) and keep \$3,840,000 (\$4,500,000 less \$660,000) of the property distributed. This compares to the shareholders retaining \$2,603,887.50 if a C Corporation sells the assets to a third party and liquidates or \$3,271,775 if the assets are sold to the family and the corporation liquidates.

F. The Subchapter S election results in more value being received by the shareholders, but has introduced the issue of a 10-year delay. The S election could still make sense today, however, even if the built-in gains tax is incurred.

**Example 14:** Whatsup makes the Subchapter S election. Given the change in capitalization rates used to value real estate in 2009, assume that the value of the land and building is fixed at \$2,245,000 (\$2,000,000 for the land and \$245,000 for the building). If within the next 10 years the land and building are sold, the built-in gains tax will apply only to \$1,900,000 of gains (\$2,245,000 which is the value of the property when the S election is made less \$345,000 of basis at that time).

In 2012, Whatsup sells all of its assets for \$4,500,000. Assume for the sake of simplicity that the basis of assets is still \$345,000. The corporation recognizes total gain of \$4,155,000 and \$1,900,000 of the

gain is subject to the built-in gains tax, but \$2,255,000 of the gain is not subject to that tax.

Whatsup pays a built-in gains tax of \$665,000 (\$1,900,000 times 35%) and distributes the net amount of \$3,835,000 (\$4,500,000 less \$665,000) to the shareholders in liquidation of the corporation.

The shareholders receive \$3,835,000 and they are allocated net gain of \$3,490,000 (\$4,155,000 less the \$665,000 built-in gains tax). Their bases in their shares is increased to \$3,590,000 (\$100,000 plus \$3,490,000) and they recognize an additional gain of \$245,000 upon liquidation (\$3,835,000 less \$3,590,000). Thus, the shareholders' total gain recognition is \$3,735,000 (\$3,490,000 plus \$245,000) and they pay a tax of \$560,250 (\$3,735,000 times 15%). The shareholders keep \$3,274,750, which is still a significant improvement over the sale of assets by a C corporation and liquidation (\$2,603,887.50).

G. Holding real estate in an S corporation is more efficient than holding it in a C Corporation. For a variety of reasons, including the following, it is not as efficient as holding it in a partnership or LLC:

1. The shareholders' bases are not increased by corporate level debt.
2. Only one class of stock may be used, so the S corporation does not lend itself to "freeze" planning as discussed below.
3. There is no step-up in basis of the S corporation assets upon the transfer of S corporation shares or upon making certain entity level distributions as is possible with a Code § 754 election in the partnership context.
4. Family partnerships and certain types of trusts are not eligible S corporation shareholders.

IX. Formation of LLC with Shareholders.

If the family can engage in longer term planning, another alternative is to create a flow through entity with the shareholders as a way to shift value to the shareholders over time.

A. A "Regular" LLC

1. The corporation and its shareholders contribute assets to a newly formed LLC in return for member units entitling them to an allocation of profits, losses and tax credits, if any, as well as a distribution of cash or property, in proportion to the value of the assets each member contributes.

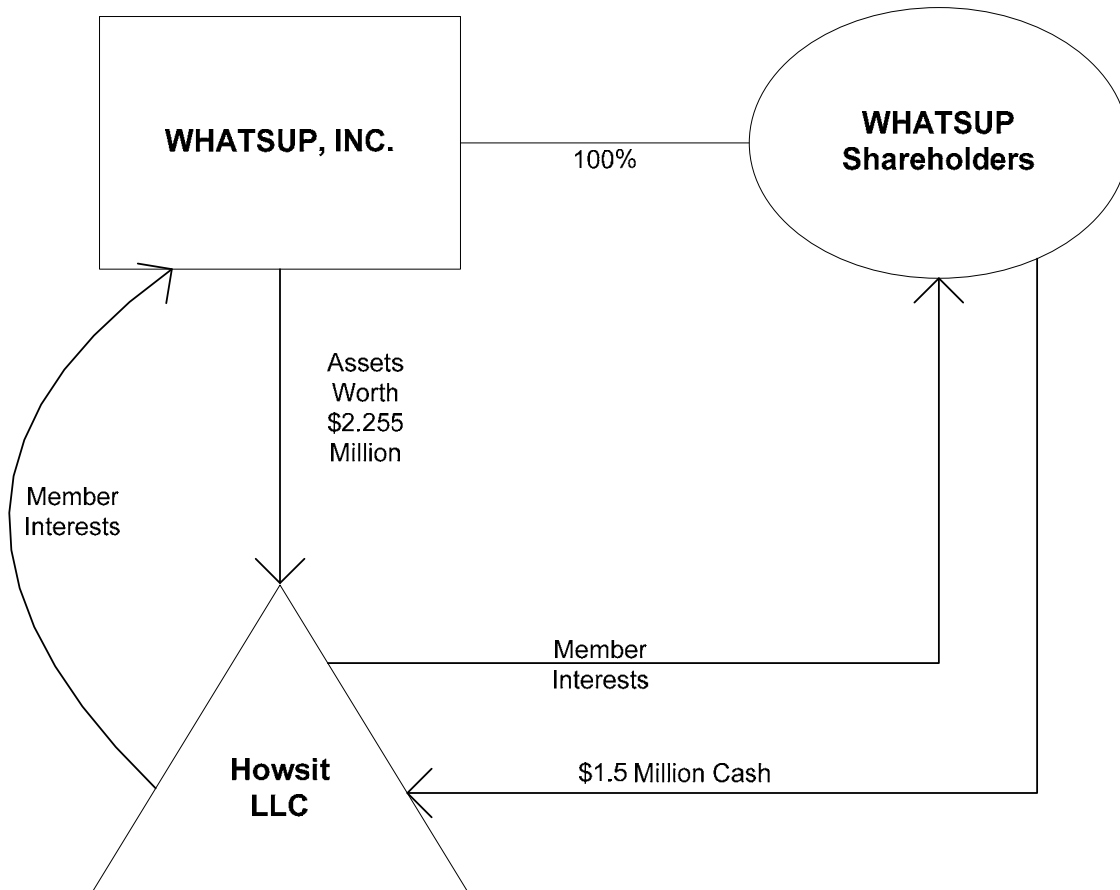
**Example 15:** Whatsup contributes the land, building and equipment which were valued at \$4,500,000 in 2008, but now have a market value of \$2,255,000, and the shareholders, as a group, contribute \$1,500,000 of cash to Howsit, a Hawaii limited liability company. In exchange for these contributions, the corporation receives 60% of all future economic profits and losses of Howsit and the Shareholders, as a group, receive 40% of all such profits and losses.

2. The contribution to Howsit is tax free to the members and to Howsit. Code §721.

3. Howsit would be required to file informational tax returns, but does not incur a federal income tax liability.

4. Profits allocated directly to the shareholder-members are subject to only one level of tax, rather than two.<sup>3</sup>

5. The effectiveness of this transaction increases as the proportion of the capital contributed by the shareholders increases. This structure can be illustrated as follows:



6. Pursuant to Code § 704(c), the \$1,910,000 built in gain (\$2,255,000 less the \$345,000 total tax basis) is allocable to the corporation.

7. The potential end game with creation of the LLC is the distribution of the interests in the LLC at a significant discount to shareholders.

(a) A minority interest discount and lack of marketability discount generally will be available for properly structured limited partnership interests or non-managing LLC interests because such equity owners have no ability to influence the operation of the entity, to withdraw from the entity or otherwise cause the entity to make current or liquidating distributions to the partner or member. The theory is that a purchaser of such an interest will pay less than the value of the underlying assets because the assets' value cannot be easily accessed through liquidation or

<sup>3</sup> As discussed above, profits earned by Whatsup are subject to a full double taxation to the extent the Whatsup's C Corporation earnings and profits are distributed to the shareholders. In addition, gains from the sale of appreciated assets also are subject to such double taxation if distributed to the shareholders.

otherwise. This raises the question of whether, after the formation of a regular or frozen LLC as described below, the corporation could distribute or sell its interest in the LLC to the shareholders at a discounted value.

**Example 16:** Whatsup contributes the land, building and FF and E which were valued at \$4,500,000 in 2008, but now have a market value of \$2,255,000, and the shareholders, as a group, contribute \$1,500,000 of cash to Howsit, a Hawaii limited liability company. The cash will be used to repair and improve the property.

The LLC would take a cost basis in the land, building and FF and E of \$345,000. Whatsup has a basis in its LLC interests of \$345,000. If the LLC ever sells the assets, the first \$1,910,000 of gain is allocated to Whatsup and the balance is split 60% to Whatsup and 40% to the shareholder-members.

In 2011, Whatsup distributes its LLC interests to the shareholders and liquidates. Assume that the LLC interests are discounted by 40% for lack of control and lack of marketability. If the assets of the LLC are worth \$4,500,000 at that time and Whatsup's share of those assets are \$2,700,000 (60%), the discounted value of Whatsup's LLC interests might be only \$1,620,000.

When Whatsup distributes the LLC interests, it is treated as if it sold the interests for \$1,620,000. Whatsup's adjusted basis in the LLC interests would be \$345,000. Thus, Whatsup recognizes \$1,275,000 of gain (\$1,620,000 less \$345,000) and pays a tax of \$446,250 (\$1,275,000 times 35%). Whatsup needs to borrow the money to pay this tax.

If Whatsup distributes the LLC interests subject to the debt, then the shareholders receive \$1,173,750 (\$1,620,000 less \$446,250). The shareholders receive assets worth \$1,173,750 in exchange for their stock with a basis of \$100,000. Thus the shareholders have capital gain income of \$1,073,750 (\$1,173,750 less \$100,000). They have a tax liability of \$161,062.50 (\$1,073,750 times 15%). The shareholders have a basis in the LLC interests of \$1,620,000 (Code § 334) plus \$1,500,000 for the cash contribution, or \$3,120,000.

If in 2012, the LLC sells the assets for \$6,000,000 and liquidates, the LLC has \$6,000,000 in net value. When the LLC sells the assets, it has a basis of \$1,845,000 (\$345,000 plus \$1,500,000) and recognizes a gain of \$4,155,000 which is passed through to the shareholders. The shareholders bases increase from \$3,120,000 to \$7,275,000. So on the distribution of the assets, the Shareholders would recognize a \$1,275,000 loss (\$6,000,000 less \$7,275,000). Thus, the shareholders' net capital gain is \$2,880,000 (\$4,155,000 less \$1,275,000) and they owe a tax of \$432,000 (\$2,880,000 times 15%).

After the payment of the capital gains tax (\$432,000) and the repayment of the loans to pay taxes (\$446,250 plus \$161,062.50), the shareholders have \$4,960,687.50 remaining. After reducing the proceeds by the amount of cash invested (\$1,500,000), the shareholders have \$3,460,687.50 for their interests from Whatsup.

(b) IRS Position if 100% of the LLC Interests are Distributed by a Corporation.

(i) Pope & Talbot Case: In Pope & Talbot, Inc. v. Comm'r, 162 F.3d 1236 (9th Cir. 1999), a corporation transferred property to a newly created limited partnership. The corporation then distributed its partnership interests pro rata to the corporation's shareholders. The corporation argued that its gain should be determined by aggregating the (discounted) value of the individual partnership units, while the IRS claimed that the gain should be calculated by treating the transactions as if the corporation transferred the property outright, without regard to the discounted value of the partnership interests.

(ii) After analyzing the legislative history of Code § 311(d) (the precursor to Code § 311(b)), the Tax Court agreed with the IRS and found that the section's purpose is to tax the appreciation in value that occurs while the distributing corporation holds the property.

(iii) The Ninth Circuit affirmed the Tax Court's holding that the gain on the distribution of the limited partnership interests should be determined as if the transferred property had been sold by the corporation at the time of distribution for its full fair market value and not by reference to the value of partnership interest received by each shareholder.

(c) TAM 200443032. In TAM 200443032, issued by IRS on October 22, 2004, a corporate taxpayer and its shareholders determined that it would be advantageous to transfer the taxpayer's manufacturing operations to various limited partnerships. The shareholders contributed an undisclosed amount of cash to the newly formed limited partnerships as operating capital and the taxpayer contributed real estate and improvements, inventory, additional operating capital, accounts receivable, and accounts payable associated with each of its manufacturing plants.

(i) After the formation of the partnerships, the taxpayer distributed limited partnership interests to its shareholders pro rata while retaining the general partnership interest in each limited partnership. It obtained appraisals of the interests for the purpose of reporting gain on the distribution. The appraised valuation was based on the value of the businesses underlying the interests, discounted by an undisclosed percentage because the interests were minority interests, and discounted by an additional undisclosed percentage because there was no public market for the interests.

(ii) The IRS disagreed with the taxpayer and ruled that for purposes of determining gain under Code § 311(b) the business assets transferred to the limited partnerships constitute the distributed property, and not the limited partnership interests. In support of its position, the IRS pointed to Pope & Talbot. The IRS ruled in the TAM that a corporate taxpayer's gain under Code § 311(b) from asset transfers to newly formed limited partnerships, followed by the pro rata distributions of the limited partnership interests to its shareholders, must be determined as if the taxpayer had sold the assets at their fair market value on the date of distribution. Thus, the values of the distributed limited partnership interests, which reflected minority and lack of marketability discounts, were to be ignored.

(d) Extending the Analysis

(i) Neither Pope & Talbot nor TAM 200443032 make clear whether the passage of time between the transfer of property to partnerships and the distribution of interests in partnerships will affect the Code § 311(b) analysis. The analysis under Code § 311 presumably should be the same as that under Code § 1001 if the corporation instead sells the partnership interests to the shareholders. Clearly, constructive dividend treatment applies to any such sale to the extent that the sales price is found to be less than the fair market value of the asset sold.

(ii) No case or ruling deals with the valuation of partnership or member interests distributed or sold to corporate shareholders in an instance where the shareholders are bona fide partners who previously have made significant independent contributions to the partnership. Arguably, the analysis set forth in Pope & Talbot and TAM 200443032 should not apply, if the partnership has been in existence for a significant period of time prior to the sale or distribution. Among the additional issues to be considered in pursuing such a transaction are the following: the step transaction doctrine and the partnership anti-abuse rules.

(iii) The contribution of assets by a corporation to partnership in exchange for an interest therein and the sale of some or all of the interest to the shareholders at the then discounted fair market value thereof a year or two after the contribution of the assets arguably should be treated as separate transactions. The corporation will bear the economic risk of a change in value of the partnership interests for the period that separates the transactions.

B. A "Frozen" LLC. Alternatively, the corporation and its shareholders could form a "freeze partnership," which may be illustrated as follows.

**Example 17:** In exchange for its contribution to Howsit, a newly-formed limited liability company, Whatsup receives a "frozen" interest in the capital and profits of the LLC that resembles preferred stock — i.e., Whatsup is entitled to a fixed return on its capital contribution at market rates (the "priority return") and is first in line for the return of its contribution upon liquidation (the "liquidation preference"). The liquidation preference typically equals the value of the corporation's capital contribution plus any arrearage in the priority return. The shareholders contribute capital to the LLC in exchange for their unfrozen, or "regular" interests. These regular interests entitle the shareholder-members to a pro rata share of all remaining LLC net profits, after payment of the corporation's priority return, and to a pro rata share of all remaining LLC assets upon liquidation, after payment of the corporation's liquidation preference.

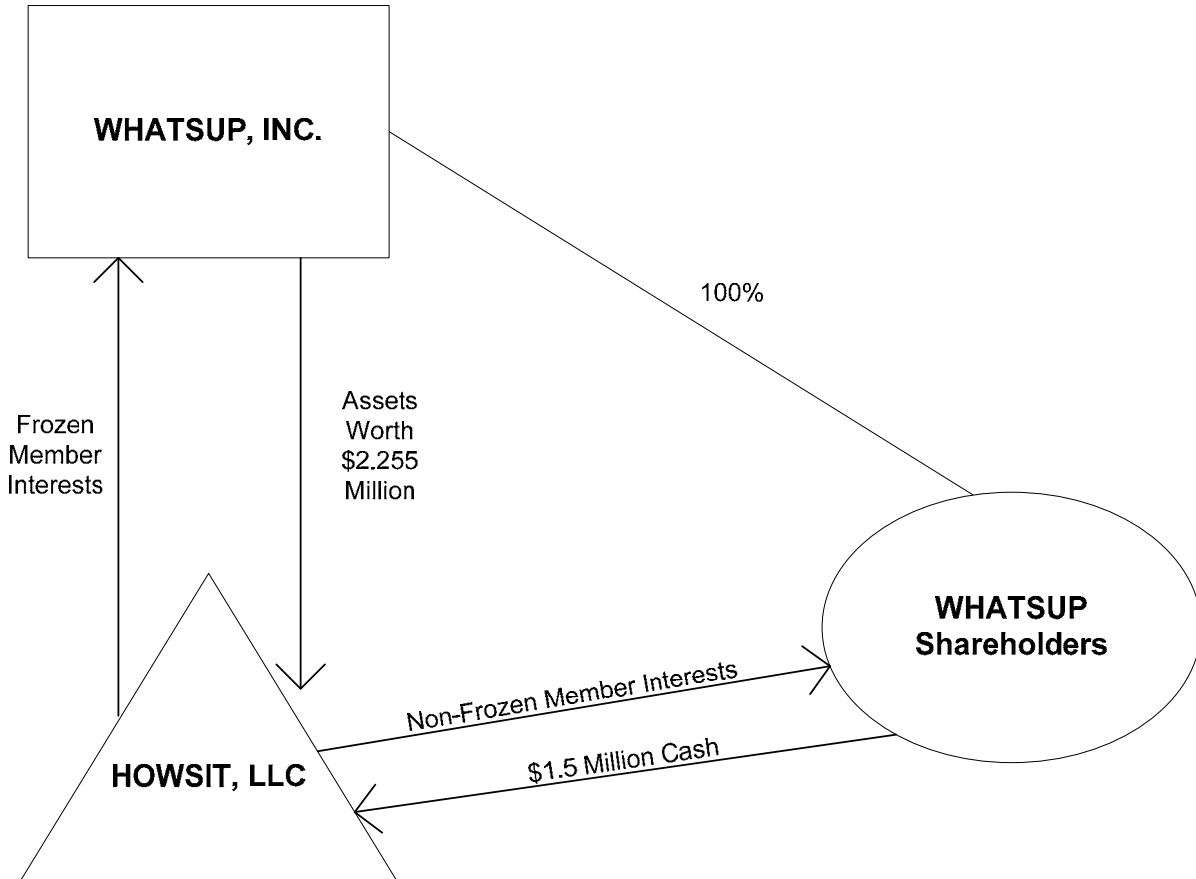
1. For income tax purposes, the LLC's profits first are allocated to the corporation until it receives profits equal to its priority return (computed on a cumulative basis). All remaining profits are allocated among the shareholder-members. Losses, if any, first are allocated among the shareholder-members to the extent of their positive capital account balances (i.e., their initial capital contributions, increased by profits and decreased by losses and distributions). Thereafter, losses would be allocated to the corporation.

2. As in the case of using a regular LLC, the contributions to Howsit are tax-free; the LLC files only an informational tax return; the tax is paid by each member according to the member's allocated share of the LLC's taxable income, which takes into account the built-in gain attributable to the corporation's contribution of appreciated property.

3. Referring to the example in Section A above, assume that a frozen LLC is formed and that Whatsup receives a priority return of 8%, or \$180,400 per year.<sup>4</sup> The frozen partnership can be illustrated as follows:

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<sup>4</sup> Actually, the proportion of "frozen" interests received by the corporation is dictated by the expected annual cash flow of the LLC. For example, if the LLC's cash flow is expected to be in the range of \$225,000, then the corporation could receive all frozen interests (\$2,255,000 times 8% = \$180,400). In order to avoid constructive dividend (and perhaps other) issues, arrearages have to be made up and should be computed on a compounded basis.



4. Assume in our example that the assets originally contributed by all members to Howsit increase in value to \$8,000,000. If there is no arrearage in Whatsup's priority return, it is entitled to receive cash or property on liquidation valued at \$2,255,000 (its liquidation preference) from its frozen interest and the remaining \$5,745,000 of cash or property is distributed to the shareholders.

5. The freeze makes sense only if the LLC has the cash flow to pay the preferred return and the total return (i.e., the current yield plus all anticipated future appreciation) attributable to the assets contributed to or acquired by the LLC is expected to exceed the priority return by a significant amount. Thus, if a total return of 15% is anticipated, a freeze requiring the payment of a 8% priority return to the corporation will serve to shift real economic value away from the corporation to the shareholder-members.

6. The greater the amount of capital contributions made by members other than the corporation, the greater the portion of LLC income and gain that can be shielded from double taxation. It is also important that the contributions of the shareholder-members be significant in absolute terms in order to demonstrate their participation in the enterprise's business risk and avoid recharacterization of the transaction as a sham or constructive dividend.

7. The mechanics of forming an LLC (with special emphasis on the freeze) are explained at greater length in Section X below.

C. Tax Considerations.

1. General. There are numerous tax considerations that affect the structure and operation of an LLC between a corporation and its shareholders. Tax issues are presented starting

with the most general rules and concluding with more specific provisions. Several factors will invite close scrutiny by the IRS and, thus, heighten the need for careful planning.

(a) First, because the shareholder-members own and ultimately control the corporation, the IRS will want to ensure that the corporation is dealing at arm's length with the LLC.

(b) Second, under these circumstances, the IRS may believe it is possible to manipulate the non-recognition rules to achieve tax results that do not reflect economic realities.

(c) Finally, recent developments illustrate that there should be a business purpose for doing the transaction, other than tax avoidance.

2. Code § 482. Code § 482 permits the IRS to reallocate income among two or more organizations controlled by the same interests in order to "clearly reflect" the income of the controlled organizations.

(a) The formation and operation of an LLC between the corporation and its shareholders is subject to this provision because the shareholders control both entities.

(b) To avoid application of this provision, the corporation and the LLC must deal with each other as would unrelated parties dealing at arm's length in a comparable transaction would deal with each other. Treas. Reg. § 1.482-1T(b). If not, the IRS may, for instance, reallocate LLC income and gain to the corporation, subjecting it to double taxation and defeating a key purpose of the transaction.

3. The Judicial "Sham" Doctrine. This doctrine, along with other common law doctrines such as the step transaction doctrine, is not found in the Code, but has been developed by federal courts applying the tax laws. Stated generally, the form of a transaction will not be respected if it does not accord with the economic substance of the parties' relationship.

(a) The basic test of whether an LLC will be respected for tax purposes under this doctrine is whether, considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. Culbertson v. Commissioner, 337 U.S. 733, 742-43 (1949).

(b) In addition, other courts such as the Seventh Circuit Court of Appeals, have held that the more stringent family partnership rules, discussed below, also control the determination whether the form of an LLC transaction will be respected. Evans v. Commissioner, 447 F.2d 547, 550-51 (7th Cir. 1971).

(c) The courts and the IRS also require that in order to be recognized as a member, a taxpayer must have some interest in the profits of the LLC. Clearly, the corporation would have a profits interest if a regular LLC is used. In the case of the frozen LLC, however, it is somewhat questionable whether a priority return alone satisfies this requirement, particularly if it is described as a guaranteed payment rather than as a preferential profit allocation.

4. Investment Company Rule. As previously noted, the formation of an LLC typically is tax-free under Code § 721(a), both for the LLC and for the contributing members. However, the so-called "investment company" rule contained in Code § 721(b) places limits on the nature of the assets that may be contributed to the LLC without triggering immediate gain to the members.

(a) Gain will be triggered if (1) the corporation's contribution to the LLC, when considered together with the cash contributions of the shareholder-members, results in a

diversification of the corporation's investments, and (2) more than 80% of the LLC contributions are readily marketable securities and other assets (such as cash, foreign currencies, and closely held stock for example). Code § 351(e)(1)(B).

(b) There is also an exception if the shareholder-members' contributions are a de minimis portion of the total contributions (i.e., less than 1% of total capital contributed).

(c) Running afoul of the investment company rule is not an issue when the majority of the assets contributed to the partnership is real estate and other operating assets.

5. Partnership "anti-abuse" regulations. In 1994, the Treasury Department issued extremely broad and controversial regulations intended to curb certain perceived abuses in transactions involving partnerships and LLCs. These regulations permit the IRS to disregard the form of a transaction and, among other things, reallocate income among the parties if an LLC is "formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K [the partnership taxation provisions]." Treas. Reg. § 1.701-2(c).

(a) In making this determination, the IRS will compare "the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction." Id.

(b) Transactions must meet the following three requirements under these regulations before the IRS is obligated to respect the form of the transaction: (1) there must be a bona fide LLC and each transaction, or series of transactions, must be entered into for a "substantial business purpose;" (2) the form of each such transaction must be respected under general "substance over form" principles; and (3) certain exceptions aside, the tax consequences of the formation and operation of the LLC must accurately reflect the members economic arrangements. Treas. Reg. §1.701-2(a).

(c) Whether a given LLC transaction meets all the requirements of these regulations will be determined under all the relevant facts and circumstances. Not surprisingly, members having a nominal interest and transitory members are likely to be disregarded. See Treas. Reg. § 1.701-2(d), Example 7.

(d) Although very little guidance is available regarding application of these provisions due to their vagueness and novelty, they may offer another way for the IRS to attack the form of the transaction. The regulations do not contain an example dealing with a corporate partnership freeze. They do, however, make it clear that forming a partnership merely to avoid double taxation attributable to C corporations is not an "abuse" to which the regulations are directed. See Treas. Reg. § 1.701-2(d), Example 1. In addition, the regulations sanction the formation of a partnership between an S corporation and a foreign investor in order to avoid the termination of the corporation's S election, provided that there are good business reasons for entering into the partnership in the first place. See Treas. Reg. § 1.701-2(d), Example 2.

6. "Family Partnership" Rules. Code § 704(e) of the Code, and regulations thereunder, contain rules limiting when a person will be recognized as a bona fide partner in a partnership and when allocations of partnership income to that person will be respected for tax purposes. These rules are aimed, in large part, at preventing senior family members from using partnerships to allocate income to younger family members in a lower tax bracket.

(a) The Seventh Circuit also has applied these rules in arm's-length transactions between unrelated parties, as mentioned above. Generally speaking, taxpayers only will be recognized as partners under these rules if they own "a capital interest in a partnership in which capital is a material income-producing factor, . . ." I.R.C. § 704(e)(1). In a partnership holding real estate and other income-producing investment assets, capital will be a "material income-producing factor."

(b) A "capital interest" is defined to mean "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." Treas. Reg. § 1.704-1(e)(1)(v).

(c) If the corporation's shareholders are not recognized as members or if allocations of income in the operating agreement are disregarded under these rules, this provides still another basis for income and gain to be reallocated to the corporation and subjected to double taxation. With proper drafting, however, these rules should be satisfied in either a regular or frozen LLC context.

7. Allocation of Income and Loss. In addition to the family partnership rules, Subchapter K includes other technical requirements with respect to the allocation of income among members. As a general rule, a member's distributive share of items of income, gain, loss, deduction, or credit are made in accordance with the LLC operating agreement unless such allocations do not have "substantial economic effect" within the meaning of the Code or otherwise do not reflect the "partners' interests in the partnership." The latter determination is made with reference to all relevant facts and circumstances.

(a) The determination of whether the allocations have substantial economic effect is made, in large part, by showing that the following three requirements are met: (1) capital accounts are maintained for each of the members in accordance with certain tax accounting principles; (2) upon liquidation of the LLC (or a member's interest therein), liquidating distributions are required to be made in accordance with the positive capital account balances of the members; and (3) one of the following requirements is satisfied: (i) a member having a deficit capital account balance following the liquidation of its LLC interest is unconditionally obligated to restore the amount of that deficit; or (ii) the operating agreement contains a "qualified income offset" provision which provides that no member will be allocated losses which cause the member's capital account to develop a deficit balance, and if a deficit balance unexpectedly arises, items of income and gain are specially allocated to the member to the extent necessary to restore the deficit balance as quickly as possible. A properly drafted operating agreement will satisfy these requirements.

(b) The contribution of appreciated (or depreciated) property (i.e., property having a fair market value different from its tax basis) causes the application of the Code § 704(c) built-in gain rules. A complete discussion of those rules is beyond the scope of this outline. However, referring to the example above, if Howsit were to sell the land, building and equipment contributed by the corporation for at least \$2,255,000 (the fair market value of those assets on the date of contribution), Code § 704(c) requires that the first \$1,910,000 of taxable gain is allocated to Whatsup as the contributing member. Any additional gain is allocated among the members in proportion to their general sharing ratios.

(c) The example is complicated by the fact that depreciable property also was contributed. In that case, Code § 704(c) requires that, for income tax purposes, the remaining tax depreciation be allocated first to the members who contributed cash (the shareholders) in amounts they would have expected to receive as if the contributed depreciable property had a tax basis equal to its fair market value on the date of contribution. The remaining tax depreciation, if any, is allocable to the member who contributed the asset. In this manner, the member who contributes depreciable assets cannot avoid the application of Code § 704(c) merely by having the LLC hold the depreciable asset until it may have no residual value so as to generate no gain on its ultimate sale or other disposition.

8. Disguised Sale Rules. Code § 707(a) contains rules that prohibit so-called "disguised sales" between a member and the LLC. Ordinarily, a member will not recognize gain upon contributing an appreciated asset to a member or upon receiving distributions of property (as opposed to money) from the LLC. Code §§ 721, 731. Moreover, gain is recognized if a member receives distributions of money from the LLC only to the extent the distribution of money exceeds the basis of the member's interest in the LLC. Thus, absent Code § 707(a), it might be possible to effectively sell or exchange an appreciated asset without recognizing gain by simply contributing the asset to an LLC and receiving a distribution of cash or other property equal to the value of the property contributed.

Code § 707(a) and the regulations thereunder require a member's contribution to be treated as a sale to the LLC if there is a related transfer of money or property back to the contributing member.

(a) Distributions made to the contributing members within 2 years of the date of the contribution are presumed to be part of a disguised sale, although the presumption is rebuttable. Treas. Reg. §§ 1.707-3(c).

(b) If, under a broad "facts and circumstances" test, (1) the LLC distribution would not have been made but for a previous transfer of appreciated property by a member; and (2) if the exchange is not simultaneous, the later transfer is not subject to the entrepreneurial risk of LLC operations, a disguised sale may be deemed to have occurred.

(c) The deemed distribution of money to the contributing member (e.g., through the allocation of debt that the LLC either assumes or takes the contributed property subject to) can also trigger the disguised sale rules. See Treas. Reg. §§ 1.707-3(b)(1) and 1.707-5.

(d) The regulations contain special safe harbors for preferred returns and preferential cash flow distributions (one of which would be required by definition in order to create frozen member interests). Generally, this safe harbor applies to distributions that do not exceed the result of multiplying (i) 150% of the highest applicable federal rate in existence at the time the preferred payment right first is granted by (ii) at the member's option, the member's unreturned capital at the beginning of the taxable year in question or the member's weighed average unreturned capital during the such year. Treas. Reg. § 1.707-4(a)(3). Given the current low AFRs, this safe harbor (which clearly does not preclude a facts and circumstances showing of no disguised sale) is of little practical help.

(e) An alternative safe harbor applies to the member's interest in operating cash flow. In order to avoid having distributions treated as disguised sale proceeds, the member may use the member's smallest percentage interest under the terms of the operating agreement in any material item of LLC income or gain that may be realized by the LLC in the three-year period beginning with such taxable year. Treas. Reg. § 1.707-4(b)(2)(ii). This safe harbor may be useful in certain limited circumstances.

(f) To the extent that any appreciated assets are, in fact, contributed by the corporation to a frozen LLC in exchange for a priority return and liquidation preference, the contribution must be structured in accordance with these rules to avoid a disguised sale triggering the recognition of gain at the time of contribution.

9. Constructive Dividend Rules. Code § 301 provides generally that distributions of property by a corporation to its shareholders with respect to their stock is subject to dividend treatment. The applicable regulations state that a corporation's transfer of property to (or for the benefit of) a shareholder for less than fair market value constitutes a distribution of property to the shareholder within the meaning of this rule. Treas. Reg. § 1.301-1(j). Likewise, Code § 311 requires the corporation to immediately recognize gain on transfers of appreciated property to shareholders when Code § 301 applies.

(a) Under these rules, the corporation's transfer of appreciated property to its shareholders for less than fair market value is treated as though the corporation first sold the appreciated property for cash and then distributed that cash to its shareholders as a dividend. Because any LLC created in this transaction would be owned and ultimately controlled by the corporation's shareholders, transfers of property from Whatsup to the LLC will likely be scrutinized to ensure that the corporation is not making a constructive dividend to its shareholder-members. As discussed below, constructive dividend concerns are avoided if the value of the LLC interests received by Whatsup equals the amount of cash and the fair market value of property the corporation contributes to the venture.

(b) In the LLC freeze context, this depends in large part upon making sure that the priority return is set at a market rate. This issue is not likely to arise if a regular LLC is used,

provided that profits and losses are allocated and cash flow is distributed proportionately to the members' capital contributions.

10. Chapter 14 Considerations.

(a) The Chapter 14 special valuation rules enacted as part of the Revenue Reconciliation Act of 1990 eliminated some of the benefits of using preferred stock or preferred interests in a partnership or LLC. However, as described below, Chapter 14 can be avoided by structuring the preferred distributions as "qualified payments."

(b) Section 2701 generally provides that, where an individual who controls a closely held business transfers an equity interest in the business (usually common stock or an equivalent partnership interest) to younger family members, while retaining a frozen interest, preferred stock or certain other interests in business immediately after the transfer (called applicable retained interests or ARIs), the retained interest will normally be assigned a zero value for gift purposes unless it is a "qualified payment" or meets certain other exceptions. If the retained preferred stock or other interest is assigned no value, the amount of its actual value will constitute an immediate gift from the transferor to the person receiving the common stock.

(c) A "qualified payment" is any dividend payable on a periodic basis, at least annually, under any cumulative preferred stock (or comparable payment under any partnership or LLC interest) to the extent such dividend is determined at a fixed rate. In addition, to avoid additional transfer tax consequences, a qualified payment should be made within four years of the due date of that qualified payment.

(d) For purposes of Section 2701, an individual will be treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust or other entity. Therefore, for purposes of the above examples, the shareholders of Whatsup will be deemed to own Whatsup's preferred interest in Howsit for purposes of applying the valuation rules of Section 2701. As a result, any preferred distributions from Howsit to Whatsup should be structured as qualified payments to avoid any adverse transfer tax consequences.

X. Structure.

A. Formation.

1. Initial Considerations.

(a) Business Purpose. The existence of a substantial business purpose for this transaction is critical to achieving the intended tax results. This is one of the first indicia a court would look to if the IRS challenged the transaction as a sham (or on other grounds) and is likely to play a major role in the IRS's application of the partnership anti-abuse regulations. Considerable attention should be given to identifying and documenting the corporation's business reasons for entering into an LLC with its shareholders. One possibility is that by transferring its investment assets to a frozen LLC, the corporation can raise funds necessary to repair or improve the property.

(b) LLC v. LP Form. Another key consideration in forming a "partnership" for tax purposes is what business form to use.

(i) The shareholders presumably do not want to expose themselves to any greater risk of personal liability than they now face as corporate shareholders. Their personal liability is now limited to the amount of capital invested in the corporation through stock purchases. This same degree of protection can be achieved by using either a limited partnership or LLC.

(ii) The main difference between these entities is that a limited partnership requires at least one general partner who remains individually liable for all partnership obligations. The liability of limited partners is similar to that of corporate shareholders. Limited

partners, moreover, are not permitted to participate in management of the partnership without losing this limited liability protection. The corporation could be designated as the general partner and manage the partnership's investments so that no individual shareholder becomes personally liable for partnership obligations.

(iii) All participants in an LLC on the other hand, are insulated from personal liability for company obligations. The LLC may be managed by its members in any manner they agree upon. Alternatively, the LLC may be managed by designated "managers," who function very much like corporate directors. With respect to limited liability and management, therefore, an LLC functions like a corporation, although, if properly structured, it will be treated as a partnership for tax purposes.

## 2. Capital Contributions and LLC interests

(a) In order to avoid a variety of tax issues (i.e., the LLC being disregarded as a sham, reallocation of income to the corporation under Code § 482, a constructive dividend to the shareholder-members, and the possible application of the partnership anti-abuse rules), it is critical that the value of the corporation's LLC interest (frozen or regular) equal the fair market value of assets it contributes to the LLC. In addition, it is advisable to give the corporation some regular interests in the LLC if a freeze is effected so that the corporation will be sure to have the participation in net profits required for recognition as a member.

(b) The main ingredient in valuing the frozen interest will be the size of the priority return. A valuation expert will be required to calculate this return based on market rates at the time of the corporation's contribution. The priority return typically is expressed as a fixed percentage return on the value of the corporation's initial capital contribution, payable only out of the LLC's net profits. This will subject the corporation's interest to the entrepreneurial risks of the business, thereby bolstering the argument that the transfer of assets to the LLC is a genuine contribution to capital, rather than a disguised sale. For various reasons, the priority return also should be cumulative (i.e., amounts that remain unpaid due to insufficient profits in a given year carry over to subsequent years).

## B. Management

1. It is with respect to management of the entity's investment activities that implementing the freeze through an LLC may be advantageous. Because limited partners cannot participate in management without risking their limited liability, only the general partner (or an employee of the general partner) could manage the partnership's day-to-day activities.

2. The parties must recognize that the new entity, whether a partnership or an LLC, will be a separate, legally distinct entity from the corporation. The entity should observe all formalities associated with its separate existence. The new entity must keep its own books and records and hold itself out to third parties as a separate organization. All dealings between the corporation and the entity, moreover, should be conducted at arm's length according to standard commercial practices. To do otherwise invites the IRS to disregard the partnership's existence and reallocate its income to the corporation.

## C. Liquidation

1. Restrictions on liquidation. As the sole general partner of a limited partnership, the corporation could not withdraw without dissolving the partnership unless another general partner were to take its place. If the corporation were to withdraw and liquidate its interest within two years of contributing investment assets to the venture, a presumption would arise that the contribution was a disguised sale to the partnership, possibly triggering gain to the corporation as of the date of contribution under the disguised sale rules discussed above. Treas. Reg. § 1.707-3(c).

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