

# UNDERSTANDING PARTNERSHIP AND LLC TAXATION

**Second Edition**

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# Chapter 1

## INTRODUCTION TO TAXATION OF PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

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### § 1.01 Overview of Rules Governing Taxation of Partnerships and Limited Liability Companies

Subchapter K of the Internal Revenue Code contains the rules governing the taxation of partners and partnerships. Ordinarily, a limited liability company (LLC) with more than one member is treated as a partnership for tax purposes. Therefore, Subchapter K generally governs the taxation of LLCs and their members. Unless otherwise noted, references to partnerships and partners throughout this text also refer to LLCs and their members.

The following sections provide a broad overview of the basic principles and rules of subchapter K. Detailed analysis of these provisions is provided in the other chapters of this book.

#### [A] Aggregate and Entity Principles of Subchapter K

The first and most basic rule set forth in Subchapter K is that a partnership is not a taxable entity.<sup>1</sup> A partnership serves as a conduit through which its income, gains, losses, deductions, and credits pass directly to its partners. Each partner reports his share of the partnership's income or loss on his individual tax return, and his personal tax liability correspondingly increases or decreases.<sup>2</sup> Thus, for reporting and paying tax liabilities, a partnership is treated as an aggregate of individuals who provide capital and services to a joint enterprise, rather than as a separate entity.

For computing the amount and timing of the income or loss passed through to its partners, however, a partnership is considered an entity that is separate and distinct from its members.<sup>3</sup> For example, partnership income is determined using a method of accounting and taxable year the partnership selects, and most tax elections affecting the amount and timing of the income and deductions are made at the partnership level.<sup>4</sup> Similarly, each partnership income or loss item generally is reported pro rata by each

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<sup>1</sup> I.R.C. § 701.

<sup>2</sup> I.R.C. § 701.

<sup>3</sup> See *U.S. v. Basye*, 410 U.S. 441 (1973).

<sup>4</sup> I.R.C. § 703(b).

partner and retains the same character it had when the partnership earned or incurred it.<sup>5</sup> The concept of a partnership as an entity also is reflected in (1) the requirement that every partner maintain a basis for his partnership interest that is distinct from the basis of the partnership's property,<sup>6</sup> and (2) the rules permitting some partner-partnership transactions to be taxed as if they occur between unrelated parties.<sup>7</sup>

## **[B] Computing and Reporting Income From Partnership or LLC Operations**

Although a partnership is not a taxable entity, it must compute and characterize the amount of income that passes through it to be reported on its partners' returns.<sup>8</sup> For this purpose, a partnership adopts its own tax year and accounting method. With important exceptions, a partnership must adopt the same tax year as the partners who own a majority of its interests.<sup>9</sup> A partnership computes its taxable income in the same manner that an individual does, except that it may not claim certain deductions that are allowed on a partner's return (*e.g.*, the standard deduction and personal exemptions).<sup>10</sup> Not included in overall partnership taxable income are partnership items that may be subject to special tax treatment on any partner's return, such as capital gains or interest; these items are accounted for and stated separately.<sup>11</sup>

Each partner reports his distributive share of partnership income, gain, loss, deduction, or credit on his tax return for the year in which, or with which, the partnership's year ends, regardless of whether any amounts are distributed to him.<sup>12</sup> Each item generally must be reported with the same character it had when the partnership earned or incurred it.<sup>13</sup> A partner may not deduct his distributive share of partnership losses that exceed the basis of his partnership interest at the close of the partnership's tax year.<sup>14</sup> Losses that cannot be deducted because of this basis limitation are carried over to subsequent years. Deductions for partnership losses also may be restricted by rules outside of subchapter K, *i.e.*, the at-risk rules of I.R.C. Section 465 and the passive loss rules of I.R.C. Section 469.

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<sup>5</sup> I.R.C. § 702(b).

<sup>6</sup> I.R.C. §§ 705, 722, 733, 742.

<sup>7</sup> See I.R.C. § 707(a), (c).

<sup>8</sup> The partnership reports its income or loss to the Service on an information return, Form 1065, and notifies each partner of his distributive share of these amounts on Schedule K-1.

<sup>9</sup> I.R.C. § 706(b).

<sup>10</sup> I.R.C. § 703(a)(1), (2).

<sup>11</sup> I.R.C. § 703(a)(1).

<sup>12</sup> I.R.C. § 706(a).

<sup>13</sup> I.R.C. § 702(a), (b).

<sup>14</sup> I.R.C. § 704(d).

## [C] Determining Distributive Shares

Each partner's distributive share of any item of partnership income, gain, loss, or deduction ordinarily is determined from the allocations the partners establish in their partnership agreement.<sup>15</sup> An allocation of any item in the agreement is disregarded if it fails to satisfy the substantial economic effect test described in the regulations.<sup>16</sup> Affected items are reallocated among the partners according to their actual interest in the partnership, as determined from all the facts and circumstances.<sup>17</sup> Tax items attributable to contributed property must be allocated in a manner that accounts for any difference between the value and basis of the property when it was contributed.<sup>18</sup> For example, when a partnership sells contributed property, the contributing partner must be allocated all of the gain up to the amount of appreciation inherent in the property at the time of the contribution.

The amount of income or loss allocated to a partner must reflect his varying interests in each portion of the year, if his interest in the partnership increases or decreases during the year.<sup>19</sup> This rule prevents partnership items from being retroactively allocated to partners who join the partnership or who increase their interests late in the partnership tax year.

## [D] Contributions to Partnership or LLC

When a partner contributes property to a partnership in exchange for a partnership interest, he generally does not recognize gain or loss.<sup>20</sup> The contributed property has the same basis for the partnership that it had in the hands of the contributing partner.<sup>21</sup> A partner's initial basis in his partnership interest is the total of cash plus the basis of any property he contributes.<sup>22</sup>

In connection with a contribution to a partnership, a partner may recognize gain or loss in the following circumstances:

- (1) A partner recognizes income if he exchanges his services for an interest in partnership capital.<sup>23</sup> The partner reports the value of the partnership interest as ordinary compensation income when he receives it.<sup>24</sup> In the year that the partner reports it as income, the partnership deducts or capitalizes the value of the interest given for the partner's services.<sup>25</sup>

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<sup>15</sup> I.R.C. § 704(a).

<sup>16</sup> I.R.C. § 704(b); Treas. Reg. § 1.704-1(b).

<sup>17</sup> *Id.*

<sup>18</sup> I.R.C. § 704(c).

<sup>19</sup> I.R.C. § 706(d).

<sup>20</sup> I.R.C. § 721(a).

<sup>21</sup> I.R.C. § 722.

<sup>22</sup> I.R.C. § 723.

<sup>23</sup> Treas. Reg. § 1.721-1(b).

<sup>24</sup> I.R.C. § 83.

<sup>25</sup> *Id.*

- (2) A partner who contributes property encumbered by a liability is deemed to receive a cash distribution equal to the transferred debt.<sup>26</sup> If the deemed cash distribution exceeds the basis of his partnership interest, the partner recognizes gain.
- (3) A partner who contributes property and receives a related distribution may be treated as if he sold, rather than contributed, the property to the partnership.<sup>27</sup>
- (4) A partner recognizes gain if he contributes property to an investment company partnership.<sup>28</sup>
- (5) Special rules apply to prevent a contribution from changing the character of income inherent in contributed property. Any unrealized receivables, inventory, or capital loss property contributed to a partnership retain the same character in the partnership that they had in the hands of the contributing partner.<sup>29</sup> Thus, a partnership recognizes ordinary income or loss on a disposition of contributed receivables or inventory. The partnership recognizes a capital loss if it sells or exchanges property that was contributed with a built-in capital loss within five years of the contribution.

### **[E] Basis of Interest in Partnership or LLC**

Each partner has a basis in his partnership interest that is separate from the partnership's basis in its assets.<sup>30</sup> In this respect, a partnership interest is treated as an interest in a separate entity comparable to stock in a corporation. A partner must know the basis for his interest for a number of tax purposes, including:

- (1) computing his gain or loss when he sells the interest;
- (2) computing his gain or loss on a distribution from the partnership;
- (3) determining his basis in property distributed by the partnership; and
- (4) determining the maximum amount of partnership losses he may deduct.

A partner's initial basis for his interest depends on how he acquires it. The basis of an interest acquired in exchange for a capital contribution is the contributed cash plus the partner's basis in any contributed property.<sup>31</sup> The basis of an interest acquired from another partner by purchase, gift, or inheritance is determined under the general basis rules of the Code.<sup>32</sup>

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<sup>26</sup> I.R.C. § 752(b).

<sup>27</sup> I.R.C. § 707(a).

<sup>28</sup> I.R.C. § 721(b).

<sup>29</sup> I.R.C. § 724.

<sup>30</sup> I.R.C. § 705.

<sup>31</sup> I.R.C. §§ 722, 723.

<sup>32</sup> I.R.C. §§ 742, 1011-1023.

Each partner is deemed (1) to make a cash contribution to the partnership that is equal to any increase in his share of partnership liabilities, and (2) to receive a cash distribution that is equal to any decrease in his share of liabilities.<sup>33</sup> Thus, when partnership liabilities change, the bases of the partners' interests also change. Each partner's basis also changes continually to reflect his share of partnership income and loss and any distributions he receives or additional contributions he makes.<sup>34</sup>

## **[F] Owner-Entity Transactions**

The tax treatment of a transaction between a partnership and one of its partners depends on the capacity in which the partner acted. A transaction between a partnership and a partner who does not act in a partner capacity generally is taxable as if it occurred between unrelated parties.<sup>35</sup> For example, a partnership may deduct payments it makes to a partner for services unrelated to his partner status, and the partner reports the payments as compensation. In determining the amount, timing, and character of the deduction and the income, both the partnership and the partner use their own tax accounting method and their own tax year. To prevent abusive arrangements, an allocation and related distribution by a partnership to a partner may be recharacterized by the Service as a payment to a nonpartner.<sup>36</sup>

Payments by a partnership for services or capital a partner provides in a partner capacity are guaranteed payments if the amount is not measured as a percentage of partnership income.<sup>37</sup> Guaranteed payments are deductible from partnership ordinary income or are capitalized, depending on the nature of the service or expense.<sup>38</sup> For example, a partnership may deduct guaranteed payments for a partner's services in managing partnership operations but must capitalize guaranteed payments for brokerage services related to acquiring partnership assets. Guaranteed payments are ordinary income for the partners and are recognized in the year the partnership deducts or capitalizes them.<sup>39</sup> A payment to a partner for services or capital that is measured as a percentage of partnership income is included in the partner's distributive share.

Special anti-abuse rules apply to transactions between partnerships and their controlling partners and between partnerships under common control.<sup>40</sup> No loss may be recognized on a sale or exchange of property between (1) a partnership and a partner who directly or indirectly owns more than

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<sup>33</sup> I.R.C. § 752.

<sup>34</sup> I.R.C. § 705.

<sup>35</sup> I.R.C. § 707(a).

<sup>36</sup> I.R.C. § 707(a)(2)(A), (B).

<sup>37</sup> I.R.C. § 707(c).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> I.R.C. §§ 707(b), 267.

50 percent of the partnership's capital or profits, or (2) between two parties in which the same parties directly or indirectly own more than 50 percent of the capital or profits.<sup>41</sup> A similar rule denies capital gain treatment on a sale or exchange of property that is not a capital asset in the hands of the purchaser.<sup>42</sup>

### [G] Distributions to Partners or Members

A partner generally may receive distributions of partnership property without recognizing gain or loss. The distribution is treated as a nontaxable withdrawal of the partner's invested capital up to the basis of his partnership interest.<sup>43</sup> This rule applies to distributions that liquidate a partner's entire partnership interest and to current distributions (*i.e.*, nonliquidating distributions).

A partner recognizes gain on a current or liquidating distribution, however, to the extent that the amount of cash he receives exceeds the basis in his partnership interest.<sup>44</sup> A partner cannot recognize a loss on a current distribution,<sup>45</sup> but he may recognize a loss on a liquidating distribution that consists solely of cash, unrealized receivables, and inventory.<sup>46</sup> The loss is the difference between the partner's basis for his interest and the sum of the distributed cash plus the partnership's basis in the distributed inventory and receivables. Any recognized gain or loss is treated as if it was realized on a sale of a partnership interest, and it ordinarily results in a capital gain or loss.<sup>47</sup>

A partner generally does not recognize gain or loss when he receives a current or liquidating distribution of property other than cash. If the distribution is current, the partner takes the property with the same basis that it had in the partnership, but the amount is limited to the basis in his partnership interest at the time of distribution less any cash distributed to him at that time.<sup>48</sup> If the distribution is liquidating, the total basis of all the property the partner receives equals the basis in his partnership interest less any cash distributed to him at that time.<sup>49</sup> Specific rules apply in allocating that basis over the distributed assets.<sup>50</sup> Gain a partner recognizes on a subsequent disposition of distributed unrealized receivables must be reported as ordinary income.<sup>51</sup> A disposition of distributed inventory within five years of the distribution also generates ordinary income.<sup>52</sup>

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<sup>41</sup> I.R.C. § 707(b).

<sup>42</sup> *Id.*

<sup>43</sup> I.R.C. § 731.

<sup>44</sup> I.R.C. § 731(a).

<sup>45</sup> I.R.C. § 731(a), (b).

<sup>46</sup> I.R.C. § 731(a)(2).

<sup>47</sup> I.R.C. § 741.

<sup>48</sup> I.R.C. § 732(a).

<sup>49</sup> I.R.C. § 732(b).

<sup>50</sup> I.R.C. § 732(c).

<sup>51</sup> I.R.C. § 735(a).

<sup>52</sup> I.R.C. § 735(b).

Special rules are provided to prevent distributions from being used to shift capital gain and ordinary income among partners. Under I.R.C. Section 751(b), a distributee partner or the partnership may recognize gain or loss on a distribution that changes any partner's proportionate interests in certain ordinary income property (*e.g.*, I.R.C. Section 751 property). These transfers are treated as if the distributee partner exchanged a portion of his interest in the I.R.C. Section 751 property for an increased share of other partnership assets or vice versa.<sup>53</sup> The partner or partnership can recognize gain or loss on this hypothetical exchange.

### **[H] Payments to Retiree or Deceased Owner's Estate**

Payments a partnership makes to completely liquidate the interest of a retiring or deceased partner are subject to special rules that allow the partnership a great deal of flexibility in planning for a partner's withdrawal.<sup>54</sup> The liquidating payments are divided into two classes: (1) amounts deemed to be for the partner's interest in partnership property,<sup>55</sup> and (2) other payments that represent the partner's distributive share of partnership income or guaranteed payments.<sup>56</sup> Payments to a partner for his share of partnership property are taxable under the rules applicable to distributions. For certain partnerships, these payments do not include amounts paid for a partner's share of goodwill unless specifically required by the partnership agreement, nor any amounts paid for his share of unrealized receivables.<sup>57</sup> Other liquidating payments are included in the partner's distributive share of partnership income to the extent that they are computed as a percentage of partnership income.<sup>58</sup> These payments cannot be deducted by the partnership. The timing for recognition and the character of the income the partner reports is determined at the partnership level. Amounts computed without regard to partnership income are treated as guaranteed payments.<sup>59</sup> These amounts may be deducted by the partnership and reported by the partner as ordinary income.

### **[I] Sale or Exchange of Partnership or LLC Interest**

A partner who sells or exchanges his partnership interest generally is deemed to transfer a discrete asset rather than his share of each item of partnership property. A partnership interest ordinarily is a capital asset; therefore, a partner realizes capital gain or loss on its sale.<sup>60</sup> I.R.C. Section

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<sup>53</sup> See Treas. Reg. § 1.751-1(b).

<sup>54</sup> I.R.C. § 736.

<sup>55</sup> I.R.C. § 736(b).

<sup>56</sup> I.R.C. § 736(a).

<sup>57</sup> I.R.C. § 736(b)(2).

<sup>58</sup> I.R.C. § 736(a)(1).

<sup>59</sup> I.R.C. § 736(a)(2).

<sup>60</sup> I.R.C. § 741.

751, however, provides rules designed to prevent conversion of the selling partner's share of the partnership's unrealized ordinary income into capital gain. Under I.R.C. Section 751, a sale of a partnership interest is divided into two parts:

- (1) the seller recognizes ordinary income or loss on the portion of the sale attributable to his share of the partnership's unrealized receivables and substantially appreciated inventory (*i.e.*, I.R.C. Section 751 property);<sup>61</sup> and
- (2) the seller recognizes capital gain or loss on the portion of the sale attributable to his share of all other partnership property.<sup>62</sup>

### **[J] Adjustments to Basis of Partnership or LLC Assets**

A partner's basis for a partnership interest acquired by sale or exchange is its cost. A partner's basis for a partnership interest acquired by inheritance is the interest's value on the date of death. Because these transfers do not affect the partnership's basis for its assets,<sup>63</sup> a disparity arises between the new partner's basis for his interest and his share of the basis of the partnership's property. To eliminate this disparity, the partnership may elect under I.R.C. Section 754 to adjust the basis of the new partner's share of partnership property to reflect its value when acquired.<sup>64</sup>

Disparities between the partners' bases for their partnership interests and the basis of partnership property also may arise as a result of certain distributions (*e.g.*, if a partner recognizes gain or loss on a distribution or if the distribution causes a change in the basis of distributed property). The same I.R.C. Section 754 basis adjustment election applicable to transfers of partnership interests applies to eliminate disparities caused by distributions.<sup>65</sup>

Once an I.R.C. Section 754 election is made, it cannot be revoked without the Service's consent. Any subsequent transfer or distribution may trigger a basis adjustment, whether or not the partner or partnership desires it.

### **[K] Termination of a Partnership or LLC**

A partnership may terminate for tax purposes even though it continues under state law. A termination occurs when (1) a partnership ceases conducting its operations in a partnership form, or (2) 50 percent or more of the interests in partnership capital and profits are sold or exchanged within a 12-month period.<sup>66</sup> When a partnership terminates because it ceases

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<sup>61</sup> I.R.C. § 751.

<sup>62</sup> I.R.C. § 741.

<sup>63</sup> I.R.C. §§ 743(a), 734(a).

<sup>64</sup> I.R.C. §§ 754, 743(b).

<sup>65</sup> I.R.C. § 734(b).

<sup>66</sup> I.R.C. § 708(b).

operations, its tax year closes and a liquidating distribution of all its assets is deemed to occur.<sup>67</sup> A partnership that terminates under the sale or exchange rule is deemed to contribute all its assets to a new partnership and then make a liquidating distribution of its interests in the new partnership.<sup>68</sup> If two or more partnerships merge or consolidate, the partnership whose members own a majority of the new entity's capital and profits continues; all other partnerships terminate.<sup>69</sup> A similar rule applies in determining whether a divided partnership continues or terminates for tax purposes.<sup>70</sup>

## § 1.02 Determining the Form of Business to Adopt

### [A] Prevalent Business Forms

Determining whether a partnership or LLC is the appropriate business form for a jointly owned endeavor requires careful consideration of a number of tax and nontax factors. This decision usually is made by comparing the relative advantages and disadvantages of conducting the venture as a partnership or LLC with the consequences of operating it as a regular corporation or as an S corporation.<sup>71</sup> A business or property that is jointly owned also may be organized as a co-ownership, a trust, a real estate investment trust (REIT), or a real estate mortgage investment company (REMIC).

#### [1] C Corporation

A corporation is established when its owners file articles of incorporation in accordance with state law. Generally, corporations are taxable under Subchapter C of the Internal Revenue Code, and thus often are referred to as "C" corporations.<sup>72</sup> Most of the rules governing corporate management, capital structure, and shareholder rights are codified in extensive and well-understood state laws. The most significant nontax aspect of a corporation is that its owners ordinarily are not personally liable for corporate debts. This feature makes the corporate format attractive to parties who wish to limit their potential losses to the capital that they invest in the venture.

The most important tax aspect of a C corporation is that its income and gains are subject to two levels of taxation (1) when the income and gains

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<sup>67</sup> I.R.C. § 706(c).

<sup>68</sup> Treas. Reg. § 1.708-1(b)(1)(iv).

<sup>69</sup> I.R.C. § 708(b)(2)(A).

<sup>70</sup> I.R.C. § 708(b)(2)(B).

<sup>71</sup> See, e.g., Holbrook-Lawrence, *Choice of Entity for Holding and Operating Real Estate: A Comparison of S Corporations and Partnerships*, 26 J. Real Est. Tax'n 22 (Fall 1998).

<sup>72</sup> Certain publicly traded partnerships also are taxable under Subchapter C and an unincorporated business entity may elect that tax treatment.

are earned by the corporation and (2) when a distribution is made to corporate shareholders. Corporate losses are deductible only against corporate income and do not pass through to the shareholders.

## [2] S Corporation

An S corporation is an incorporated entity whose shareholders elect to have the venture taxed under Subchapter S of the Internal Revenue Code instead of under Subchapter C. Many corporations are not eligible for this election because the number and the kind of shareholders that S corporations may have is significantly limited. An eligible corporation can elect Subchapter S treatment at its inception, or it may operate as a C corporation and convert to an S corporation later. Similarly, a corporation that operates under Subchapter S may terminate its election and convert to a C corporation.

For nontax purposes, S and C corporations are treated in the same manner and are subject to the same state laws. Thus, shareholders of S corporations are not personally liable for corporate obligations. A significant difference between S and C corporations is that an S corporation is limited to one class of stock,<sup>73</sup> whereas a C corporation may issue various stock classes.

The main tax effect of a Subchapter S election is that the corporation's income, deductions, gains, and losses generally are not subject to taxation at the corporate level. Instead, these tax items pass through to the shareholders, who report their shares of each corporate item on their personal tax returns. A corporate level tax may be imposed, however, on certain income of S corporations that formerly operated as C corporations.

In many respects, shareholders of S corporations are taxable in the same manner as the partners of a partnership. As discussed below, however, a number of important differences between partnership and S corporation taxation exist.

## [3] Partnership

Unincorporated ventures with multiple owners typically are considered partnerships for state law and tax purposes. Most partnerships are general partnerships, meaning that each partner is an agent for the venture whose actions may bind the other partners.<sup>74</sup> Every general partner is personally liable for all partnership obligations; a general partner's personal assets are potentially at risk if the venture is unsuccessful.<sup>75</sup> Partners may organize and operate their partnership informally pursuant to an unwritten understanding, or they may formalize their arrangement through a written partnership agreement.

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<sup>73</sup> I.R.C. § 1371.

<sup>74</sup> U.P.A. §§ 13, 14.

<sup>75</sup> U.P.A. § 15.

General partnerships are taxable under Subchapter K of the Internal Revenue Code. The main tax feature of a partnership is that no tax is imposed at the partnership level. Instead, each partner reports his share of each item of the partnership's gain, loss, income, deduction, or credit on his personal tax return. Joint ventures engaged in specific types of activities may elect to be excluded from the tax rules of Subchapter K; these ventures are treated as co-ownerships.<sup>76</sup> Certain publicly traded partnerships are excluded from Subchapter K and are taxable as C corporations.<sup>77</sup>

#### **[4] Limited Partnership**

A second kind of partnership is a limited partnership, which is formed by executing and filing a written instrument in accordance with state statutes.<sup>78</sup> A limited partnership must have at least one general partner that bears personal liability for partnership obligations.<sup>79</sup> The limited partner's status is similar to that of a corporate shareholder: limited partners cannot directly manage partnership business affairs; they cannot bind the partnership; and their liability for partnership obligations is limited to the capital they have invested. Limited partnerships are taxable under Subchapter K in the same manner as general partnerships.

#### **[5] Limited Liability Partnership**

Many states have enacted statutes that permit a general partnership to register as a limited liability partnership (LLP) or registered limited liability partnership (RLLP).<sup>80</sup> Members of a partnership that registers as an LLP or RLLP are not personally liable for certain kinds of partnership debts. Although the scope of liability protection differs considerably from state to state, most LLP statutes shield partners from personal liability for (1) the negligence, malpractice, malfeasance, and wrongdoing of other partners or of persons under other partners' supervision and control, and (2) indirect liability to other partners through contribution, indemnification, or assessment. Some states extend liability protection to other partnership debts and obligations. Partners continue to be personally liable, however, for their own negligence or misconduct and for wrongful conduct or negligence of persons under their direct supervision or control.

#### **[6] Limited Liability Company**

All states have enacted statutes that permit the formation of a business entity called a Limited Liability Company (LLC). The LLC combines the limited liability of a corporation with the flexibility and tax advantages of

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<sup>76</sup> I.R.C. § 761(a).

<sup>77</sup> I.R.C. § 7704.

<sup>78</sup> See U.L.P.A. § 2; R.U.L.P.A. § 201.

<sup>79</sup> U.L.P.A. § 1; R.U.L.P.A. § 101.

<sup>80</sup> See, for example, the Illinois LLP statute in 805 ILCS 205/8.1-205/15. See also Rev. Rul. 95-55, 1995-2 C.B. 313 (New York general partnership registered as RLLP).

a partnership. If the LLC is properly formed and operated under state law, its members are not personally liable for the entity's debts and obligations. An LLC that has at least two members is classified as a partnership for federal tax purposes unless the members elect to be taxed as a corporation. An LLC's income, gain, loss and deduction flow through to its members who report their distributive shares of these items in the same manner as partners of a partnership.

Generally, a member's rights concerning matters such as the LLC's governance, operations, transfer of interests, income, distributions, and liquidation are set forth in an operating agreement that is similar to a partnership agreement. The members of an LLC may manage the business directly or they may delegate some or all managerial functions to other members or to hired managers. Unlike a limited partnership, an LLC member who participates in management does not forfeit limited liability under state law.

### **[7] Co-ownership**

In a co-ownership, each co-owner is deemed to own an undivided portion of the mutually held property. One co-owner is not an agent for other co-owners and cannot bind or create obligations for them. An arrangement is considered a co-ownership if it involves the passive holding of property and if the owners do not engage in any significant business activities. If the owners actively participate in operating the property, their arrangement is likely to be considered a partnership for state law and tax purposes.

A co-ownership arrangement can have markedly different tax consequences than a partnership. For example, most tax elections in a partnership are made at the partnership level and bind all of the partners.<sup>81</sup> These elections include the use of installment-method reporting, selection of the partnership's tax accounting method, and the election of nonrecognition on like-kind exchanges. In contrast, each co-owner is free to make his own elections on the tax treatment of various items, which may result in each of the co-owners using a different method. Unlike a partnership, co-owners share most tax items in proportion to their interests in the property; they cannot contractually allocate various income and loss items among themselves.

### **[B] Factors to Consider in Choosing Business Form**

In choosing the appropriate form for a business venture, investors must consider a number of nontax factors relating to its organization and operation. In some situations, these nontax objectives mandate the kind of entity that must be used. Frequently, more than one kind of entity can be used to meet the investors' goals. For example, an enterprise that requires limited liability can be structured as a C corporation, an S corporation, a limited liability company, a registered limited liability

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<sup>81</sup> I.R.C. § 703(b).

partnership or a limited partnership with a corporate general partner. When more than one form of organization meets the investors' goals, tax considerations become paramount in determining the choice of entity.

## **[1] Nontax Factors**

### **[a] Limited Liability**

Business owners often wish to protect their personal assets from business creditors' claims. Typically, this goal is attained by organizing the venture under a state law that limits the owners' liability to the amount of capital they have invested in the entity. The broadest form of statutory limited liability from all creditors is afforded to shareholders of a corporation (taxable under either Subchapter C or S) and to members of a limited liability company (LLC).<sup>82</sup> Many states have enacted statutes permitting a general partnership to register with a designated state office as a limited liability partnership (LLP). Although the scope of liability protection varies from state to state, partners of a registered LLP typically are not liable for debts arising from torts but remain liable for other partnership obligations.

In some business situations, complete limited liability is not possible. Although many states permit professionals to operate their practices as a corporation, LLC or LLP, the professionals generally remain personally liable for their own malpractice and for the acts of persons under their direct control. These entities can, however, provide liability protection against the malpractice of other professionals and against debts to general creditors. Owners of a closely held business often cannot insulate themselves from business debts because creditors demand personal guarantees for their obligations.

In many situations, investors can insulate their personal assets from business debts by operating as a limited partnership. In a partnership, all partners other than limited partners are jointly liable for partnership obligations and are jointly and severally liable for obligations that arise from another partner's wrongful act or breach of trust.<sup>83</sup> Under state law, limited partners are not liable for partnership obligations that exceed their capital contributions. This protection against personal liability is not available to limited partners who participate in managing the partnership's business affairs.<sup>84</sup> A limited partnership must have at least one general partner whose individual assets may be reached by partnership creditors. Many ventures reduce the total amount of nonbusiness assets at risk in the enterprise by having a corporation act as the general partner. This arrangement limits the total liability of all investors to the amount of

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<sup>82</sup> An LLC formed under one state's laws may not have limited liability for operations in another state unless it takes all necessary steps to qualify for doing business in that jurisdiction.

<sup>83</sup> U.P.A. §§ 13, 14, 15.

<sup>84</sup> U.P.A. § 7; R.U.L.P.A. § 303(a).

capital invested in the partnership and the capital owned by the corporate general partner.

### **[b] Management and Control Arrangements**

Business owners should consider how each business form affects the way they may operate and control their enterprise. Corporations are centrally managed by a board of directors that acts in a representative capacity for the shareholders who elect them.<sup>85</sup> Thus, shareholders generally lack direct, immediate control over corporate operations and managerial decisions. Shareholders of closely held corporations, however, can directly control corporate operations by serving as directors and officers.

General partnerships usually allow more flexibility than corporations in structuring management and control arrangements because partners can specify each party's managerial role through appropriate provisions in the partnership agreement. The agreement may grant any partner or group of partners control over all business affairs, or it may limit their discretion to particular kinds of decisions. For example, the partnership agreement can ensure a dominant role for minority partners by giving them control over certain key business decisions. In contrast, a similar corporate arrangement for minority shareholders would require complex voting agreements or voting trusts.

The control and management of a limited partnership is closer to the corporate structure than that of a general partnership because the general partners provide central management for the limited partners. Management by general partners is required because if a limited partner participates directly in partnership business affairs, he becomes personally liable for partnership obligations.<sup>86</sup> Limited partners may vote on, and thereby control, however, a number of important partnership business activities without losing their limited liability status.<sup>87</sup> For example, limited partners may consult and advise the general partners about the partnership's business and may propose, approve, or disapprove of actions, such as making changes in the nature of the partnership's business and incurring debts outside the ordinary course of partnership business.<sup>88</sup>

Unlike limited partners, all members of an LLC may participate directly in management without losing their limited liability protection. The governance of a member-managed LLC is similar to a general partnership. Alternatively, the LLC operating agreement may require governance by hired managers who are not members. Governance of a hired-manager LLC is similar to a corporation and members exercise indirect control through their selection of the outside managers.

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<sup>85</sup> See, e.g., Model Business Corporation Act § 35.

<sup>86</sup> See U.L.P.A. §§ 7, 9; R.U.L.P.A. §§ 303, 403.

<sup>87</sup> See, e.g., R.U.L.P.A. § 303(b).

<sup>88</sup> *Id.*

### **[c] Capital Structure**

Investors should consider how the capital structure of each business form affects the way they share its income, profits, capital, and losses. Partnerships and limited liability companies generally provide the most flexibility in allocating these items among business owners because partners and LLC members may contractually agree to share any item of partnership gain, loss, income, or expense to best meet the individual partners' financial and tax goals. For example, one partner may be given a greater share of the appreciation (and corresponding depreciation) of certain partnership assets, while another partner may obtain a larger share of the partnership's operating income or loss. The sharing arrangement the partners express in their partnership agreement ordinarily is respected under state law.<sup>89</sup> An allocation in the partnership agreement is respected for tax purposes if it has substantial economic effect, that is, it substantially affects the values of the partners' interests independent of tax consequences.<sup>90</sup>

Somewhat less flexibility is available in allocating the economic consequences of corporate activities among shareholders. A regular corporation can create different interests in its capital appreciation and operating income by issuing various classes of common stocks, preferred stocks, debt instruments, and hybrid securities. An S corporation is even more restrictive, because its capital structure is limited to one class of common stock, and no hybrid securities are permitted.<sup>91</sup>

### **[d] Transferability of Interests**

Owners of business or investment interests should consider how the choice of business form affects their ability to sell or otherwise transfer their interests. Partnership interests, other than limited partnership interests, ordinarily are not readily transferable because all general partners must consent to the transfer. This feature protects the continuing partners against unwanted new partners whose actions can bind the partnership. Although a partner may assign his right to receive his share of partnership profits and capital, the assignee does not become a partner with rights to participate in partnership management unless all of the other partners consent.<sup>92</sup>

Most constraints on transferability do not apply to limited partnership interests. Limited partners may freely assign their interests, and the assignee obtains the assignor's right to share in partnership profits.<sup>93</sup> Because limited partners do not participate in partnership management, an assignment of a limited partner's interest in partnership profits is equivalent to a sale of the interest. Also, the partnership agreement may

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<sup>89</sup> See U.P.A. § 18; U.L.P.A. § 14; R.U.L.P.A. § 503.

<sup>90</sup> I.R.C. § 704(b).

<sup>91</sup> I.R.C. § 1361.

<sup>92</sup> U.P.A. § 27.

<sup>93</sup> U.L.P.A. § 19; R.U.L.P.A. §§ 702, 704.

allow an assignee to become a substitute limited partner, with rights to inspect partnership books and to vote on certain matters, without the consent of the other partners.<sup>94</sup>

Corporate stock theoretically is a more liquid form of investment than a partnership interest because shareholders may transfer their shares without anyone's consent, and the transferee obtains all the transferor's rights and interests. In a closely held corporation, however, a shareholder's right to transfer his shares is likely to be subject to substantial contractual or statutory restrictions.<sup>95</sup> These restrictions usually preclude stock transfers that affect control of corporate affairs; therefore, little difference exists between the liquidity of closely held corporate stock and partnership interests.

The limited liability company provides a great deal of flexibility in determining the transferability of members' interests. Generally, transfer rights are governed by the LLC operating agreement. The agreement can provide that a transferee of an interest automatically is admitted as a substitute member, or it may require the consent of some or all members for the transferee to be admitted. A member who cannot transfer his interest to a new member may freely assign it; the assignee obtains the assignor's right to share in profits but does not receive any other membership rights.

### **[e] Death or Other Withdrawal of Owner**

Investors should consider the consequences of any member's death, disability, or retirement. In a partnership, a partner's withdrawal causes a dissolution that negates every partner's authority to act as the partnership's agent except in matters relating to the wind up of its affairs.<sup>96</sup> The dissolution generally protects the withdrawing partner, or his successor, from personal liability for future obligations incurred by the other partners.<sup>97</sup>

A dissolution does not terminate the partnership's business, however; the remaining partners may continue its operations.<sup>98</sup> The continuing partners' obligations to liquidate or to purchase the interest of a deceased or retiring partner are usually specified in a buy-sell agreement. The parties also may agree in advance that a deceased partner's successor may join the partnership in continuing its business.

The effect of a member's withdrawal from a limited liability company is similar to a partnership. Generally, a limited liability company dissolves under state law upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member or whenever a member's interest in the

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<sup>94</sup> *Id.*

<sup>95</sup> See, e.g., Delaware General Corporation Law § 347.

<sup>96</sup> U.P.A. § 33.

<sup>97</sup> But see U.P.A. § 35 (partnership may be bound after dissolution with respect to certain third parties without notice of dissolution).

<sup>98</sup> U.P.A. § 38.

LLC terminates. However, most states permit the remaining members to elect to continue the LLC's business. If only one member remains, the LLC will no longer be taxable as a partnership unless a new member is admitted.

A corporation does not dissolve or terminate when a shareholder dies or otherwise withdraws. In a closely held corporation, however, the lack of a ready market for the corporation's stock often means that the practical effect of a shareholder's withdrawal is the same as a partner's withdrawal from a partnership. Thus, the corporation's business will terminate unless the other owners are willing and able to continue its operations. As in a partnership, the obligation of the continuing shareholders to liquidate or to purchase the stock of a deceased or retired shareholder may be specified in a buy-sell agreement.

A limited partnership does not dissolve or terminate when a limited partner withdraws. The partnership agreement typically specifies the time when a withdrawing limited partner is entitled to receive a distribution of the value of his interest. If the agreement is silent, the limited partner must receive a distribution of his capital after six months' notice to the other partners.<sup>99</sup> The partnership agreement may contain a provision allowing a limited partner to designate his estate or other successor as a substitute limited partner.<sup>100</sup> Withdrawal of less than all of the general partners does not dissolve a limited partnership if the remaining general partners are authorized to continue partnership business operations.<sup>101</sup>

## **[2] Tax Factors**

### **[a] Tax Consequences of Capital Contributions**

The tax treatment of cash contributions to corporations and partnerships<sup>102</sup> is similar. No gain or loss is recognized, and the contributor's basis for the stock or interest he receives equals the amount of cash he contributes.

If property is contributed, however, the tax consequences to corporations and partnerships can differ significantly. In a partnership, any gain or loss inherent in contributed property is deferred until the partnership sells the asset or the contributing partner sells his partnership interest. The contributing partner does not recognize gain or loss at the time of contribution, regardless of his percentage of ownership in the partnership.<sup>103</sup> The contributor's basis for the property carries over to the partnership,<sup>104</sup> and

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<sup>99</sup> U.L.P.A. § 16(2); R.U.L.P.A. § 603.

<sup>100</sup> U.L.P.A. § 2(1)(a); R.U.L.P.A. § 201(a)(7).

<sup>101</sup> U.L.P.A. § 20, R.U.L.P.A. § 801. The authority may be in the partnership agreement or may be provided by consent of all the members of the partnership.

<sup>102</sup> It is important to keep in mind that all tax rules applicable to partnerships and partners apply equally to limited liability companies and their members.

<sup>103</sup> I.R.C. § 721.

<sup>104</sup> I.R.C. § 723.

it also becomes the basis for the partnership interest he receives.<sup>105</sup> When the partnership sells the contributed property, the gain or loss that was not recognized at the time of contribution is recognized and allocated to the contributing partner.<sup>106</sup>

In contrast, a transfer of appreciated property to a regular or S corporation in exchange for stock is a taxable transaction unless the transferor, together with other parties making contributions at the same time, control the corporation through ownership of at least 80 percent of its stock.<sup>107</sup> If the transfer satisfies this control requirement, no gain or loss is recognized, the contributing shareholder's basis for the property carries over to the corporation, and it becomes the basis for the stock he receives.<sup>108</sup> In a C corporation, the corporation is taxable on any gain or loss when it disposes of the contributed property, and there are no current tax consequences to the shareholders. In an S Corporation, gain or loss that the corporation recognizes when it disposes of the property passes through to the shareholders in proportion to their stock ownership.<sup>109</sup> Unlike what happens in a partnership, the gain or loss is not allocated to the contributing shareholder.

## [b] Ownership Restrictions

An entity, including a limited liability company, may be a partnership for tax purposes regardless of the nature or the number of its partners or the kind of activities in which it engages. Thus, its partners or members may consist of any number of domestic or foreign individuals, corporations, trusts, estates, tax-exempt organizations, or other partnerships. Generally, an unincorporated business entity with more than one owner is taxed as a partnership unless it elects to be treated as a corporation (see classification rules in Chapter 2). Certain joint ventures involving passive property ownership or natural resource extraction, however, may elect to be excluded from the Subchapter K rules and treated as co-ownerships.<sup>110</sup>

As is the case in a partnership, no restrictions are imposed on the nature and number of shareholders of C corporations; these corporations may engage in any kind of activity their charters permit. Taxation under Subchapter C is not elective for any entity that is incorporated under local law, but certain unincorporated entities may elect to be treated as a corporation. (See Chapter 2). Eligible corporations may be excluded from the rules of Subchapter C by electing to be taxed under Subchapter S.

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<sup>105</sup> I.R.C. § 722.

<sup>106</sup> I.R.C. § 704(c)(1)(A). The contributing partner also recognizes gain or loss if the partnership distributes the contributed property to another partner within five years of the contribution date. I.R.C. § 704(c)(1)(B).

<sup>107</sup> I.R.C. § 351.

<sup>108</sup> I.R.C. §§ 358, 362.

<sup>109</sup> I.R.C. § 1366.

<sup>110</sup> I.R.C. § 761.

Subchapter S corporations are subject to important limitations on the number and the kind of shareholders they may have. No more than 75 shareholders are permitted, and all shareholders must be individuals who are U.S. citizens or residents, estates, or certain kinds of trusts.<sup>111</sup> Thus, S corporations exclude an important segment of potential investors, including venture capital firms, ESOPS, and foreign nationals. Although a C corporation cannot own S corporation stock, an S corporation is permitted have wholly-owned C corporation subsidiaries.<sup>112</sup> An election to be taxable under Subchapter S requires the unanimous consent of the corporation's shareholders.<sup>113</sup>

### [c] Taxability of Income and Loss

For tax purposes, a partnership or LLC is not a separate tax-paying entity.<sup>114</sup> Each partner or member is separately and individually taxable on his share of partnership or LLC profits, losses, deductions, and credits.<sup>115</sup> Each partner or member reports his share of each tax item, and each item retains the same character it had when earned or incurred by the partnership or LLC.<sup>116</sup> The pass-through of items to partners and LLC members means that income avoids the double tax imposed on corporate income and that losses may offset income the partner or member has from other sources.

In contrast, a C corporation is a separate, tax-paying entity. Thus, its income and profits are taxed at the corporate level when earned, and these amounts are subject to a second tax when distributed to shareholders as dividends. Dividends always are taxable as ordinary income, regardless of the source of the earnings at the corporate level.<sup>117</sup>

The taxation of S corporations is similar to the treatment of partnerships. An S corporation is not a taxable entity; it serves as a conduit through which its income and losses pass through to shareholders.<sup>118</sup> Each shareholder reports his share of each tax item on his tax return, and these items retain the same character they had when they were earned or incurred by the S corporation.<sup>119</sup> Although a partnership is never treated as a taxable entity, an S Corporation may be taxable if it once operated as a C corporation. Corporate-level taxation may result if excessive passive-type income is generated by corporate assets<sup>120</sup> or if the corporation disposes of assets that had built-in gain when the S election occurred.<sup>121</sup>

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<sup>111</sup> I.R.C. § 1361.

<sup>112</sup> I.R.C. § 1361(b)(2).

<sup>113</sup> I.R.C. § 1362.

<sup>114</sup> I.R.C. § 701.

<sup>115</sup> I.R.C. §§ 701, 702.

<sup>116</sup> I.R.C. § 702(b).

<sup>117</sup> I.R.C. § 301.

<sup>118</sup> I.R.C. § 1366.

<sup>119</sup> *Id.*

<sup>120</sup> I.R.C. § 1375.

<sup>121</sup> I.R.C. § 1374.

### **[d] Allocations of Income or Loss Items**

The partnership and LLC provide the most flexibility for allocating income, losses, deductions, and credits among the partners or members in accordance with their individual investment and tax goals. The owners may establish their shares of each partnership or LLC item through appropriate provisions in their partnership or operating agreement.<sup>122</sup> An allocation set forth in the agreement is respected for tax purposes unless tests contained in the regulations determine that it lacks substantial economic effect.<sup>123</sup> Because a carefully drafted agreement ordinarily satisfies these tests, most allocations of partnership or LLC tax items are valid.

Investors in a C corporation can create some flexibility for allocating income and capital appreciation among themselves by issuing different classes of common and preferred stock and sophisticated debt instruments.

Little flexibility is available to S corporations. Unlike C corporations, S corporations are permitted only one class of common stock. Although voting rights may differ, preferred stock cannot be used to create different interests in corporate capital and income. Some differences in the cash flow allocated among S corporation shareholders can be effected if a portion of their capital is provided as loans rather than as capital contributions. Because the use of sophisticated hybrid securities may be characterized as a prohibited second class of stock, their use is precluded.

### **[e] Basis Limitation on Deductibility of Losses**

Taxpayers who wish to use losses from a business or investment activity to offset their income from other sources must structure the venture to be taxable as a partnership (which includes an LLC) or S corporation. A partner generally may deduct his share of losses up to the basis of his partnership interest and an S corporation shareholder may deduct losses up to the basis for his stock. In contrast, losses of a C corporation do not pass through to the shareholders; they must be carried back or carried over to offset future corporate income.

For ventures that use significant amounts of borrowed funds, a partnership or LLC is the preferred organization form because the basis of a partner's interest increases by his share of the partnership's liabilities.<sup>124</sup> Each partner is treated as if he personally borrowed his share of the partnership's obligations and contributed that amount of cash to the partnership, even if the partnership debt is nonrecourse (*i.e.*, no partner is personally liable for repayment of the debt). The resulting basis increase enables partners to deduct losses attributable to funds the partnership borrows.

In contrast, a shareholder's basis for stock in an S corporation does not include corporate liabilities, other than loans the shareholder makes

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<sup>122</sup> I.R.C. § 704(a).

<sup>123</sup> I.R.C. § 704(b); Treas. Reg. § 1.704-1(b).

<sup>124</sup> I.R.C. §§ 752, 722.

directly to the corporation;<sup>125</sup> therefore, corporate obligations to third parties do not increase a shareholder's basis. A shareholder can increase the basis of his stock by borrowing funds personally and lending or contributing the proceeds to the corporation. When the loan must be directly secured by corporate assets, however, this transaction is not possible in practice. Highly leveraged ventures usually are organized as limited partnerships or LLCs because partners can deduct significantly greater losses than S corporation shareholders who make the same out-of-pocket investment.

### **[f] Loss Limitations Under the At-Risk and Passive Activity Rules**

Tax provisions outside of Subchapters K and S may bar certain deductions even if a partner, LLC member or shareholder has sufficient basis in his partnership interest or stock. Losses may be restricted under I.R.C. Section 465 to the extent that they are attributable to nonrecourse liabilities. I.R.C. Section 465 limits a taxpayer's deductions for losses from an activity to the amount he has at risk in the activity at the end of the tax year (*i.e.*, his capital contribution plus liabilities for which he bears personal liability). This limitation does not apply to qualified nonrecourse financing used in real estate activities. The at-risk rules apply to certain closely held C corporations.<sup>126</sup>

Under I.R.C. Section 469, certain taxpayers cannot deduct losses incurred in passive activities that exceed their income from other passive activities. Taxpayers subject to these limitations include individuals, estates, trusts, closely held C corporations, and personal service corporations.<sup>127</sup> An activity is passive for these taxpayers if it is a trade or business in which they do not materially participate.

The passive loss rules are applied to partners, LLC members and S corporation shareholders in a similar manner. Based on his participation in each partnership or corporate activity, each partner or shareholder separately determines if his income or loss from the activity is passive. With important exceptions, a limited partner's share of all partnership income or loss is passive.<sup>128</sup> The passive loss rules apply only in a modified form to closely held C corporations. (A C corporation is closely held if, at any time during the last half of its taxable year, five or fewer individuals directly

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<sup>125</sup> I.R.C. § 1366(d). *See* *Uri v. Comm'r*, 949 F.2d 371 (10th Cir. 1991) (shareholders who personally guarantee S corporation loan cannot increase basis in stock by pro rata amount of guarantee); *Estate of Leavitt v. Comm'r*, 90 T.C. 206 (1988), *aff'd*, 875 F.2d 420 (4th Cir. 1988), *cert. denied*, 493 U.S. 958 (1989); *Brown v. Comm'r*, 706 F.2d 755, 756 (6th Cir. 1983); *Goatcher v. U.S.*, 944 F.2d 747 (10th Cir. 1991); *Harris v. U.S.*, 902 F.2d 439 (5th Cir. 1990). *But see* *Selfe v. U.S.*, 778 F.2d 769 (11th Cir. 1985) (pro-rata inclusion of personal loan guarantees in shareholder's stock basis allowed where lender looked primarily to shareholder for repayment).

<sup>126</sup> I.R.C. § 465(a).

<sup>127</sup> I.R.C. § 469(a)(2). Personal service corporations are defined under I.R.C. § 469(j)(2).

<sup>128</sup> I.R.C. § 469(e)(1).

or indirectly owned more than 50 percent of the value of its stock.)<sup>129</sup> Closely held corporations may not use passive losses and credits to offset portfolio income but may use them to offset income from an active business.

The passive loss limitations fully apply to personal service corporations. A C corporation is a personal service corporation if (1) its principal activity is performing personal services that employee-owners substantially performed,<sup>130</sup> and (2) all of the employee-owners together own more than 10 percent of the value of the corporation's stock.<sup>131</sup>

## [g] Distributions

A liquidating or nonliquidating distribution from a partnership to a partner generally is treated as a nontaxable return of the partner's capital. The partner recognizes no gain until he receives cash exceeding the basis of his partnership interest.<sup>132</sup> The partner recognizes no gain on noncash property distributions. The partner defers any gain not recognized when the distribution occurs and recognizes it when he subsequently disposes of the distributed property.<sup>133</sup> A partner may recognize a loss on a liquidating distribution if the only property he receives consists of cash, unrealized receivables, or inventory.<sup>134</sup> These rules also apply to limited liability companies.

Like partnership distributions, cash distributions from an S corporation generally are considered a nontaxable return of capital up to the shareholder's basis for his stock; the excess is considered capital gain.<sup>135</sup> An S corporation's property distributions, however, are treated quite differently than a partnership's property distributions. The S corporation is deemed to sell the distributed property to the shareholder, and the corporation recognizes any gain or loss inherent in the property when the distribution occurs.<sup>136</sup> That gain passes through to the shareholders and is taxable to them in the year the distribution occurs.<sup>137</sup>

Cash distributions from C corporations are taxable to the shareholders as dividends to the extent of the corporation's earnings and profits.<sup>138</sup>

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<sup>129</sup> Treas. Reg. § 1.469-1T(g)(2)(i).

<sup>130</sup> I.R.C. § 469(j)(2), citing to I.R.C. § 269A(b)(2).

<sup>131</sup> I.R.C. § 469(j)(2)(B).

<sup>132</sup> I.R.C. § 731(a)(1).

<sup>133</sup> Gain or loss may be recognized under I.R.C. § 751(b), however, if the distribution changes a partner's share of certain partnership ordinary income property.

<sup>134</sup> I.R.C. § 731(a)(2).

<sup>135</sup> I.R.C. § 1368(b). Certain cash distributions may be taxable, however, if attributable to earnings and profits accumulated under Subchapter C before the corporation elected to be taxed under Subchapter S. I.R.C. § 1368(e).

<sup>136</sup> I.R.C. §§ 311, 1371(a).

<sup>137</sup> I.R.C. § 1366. However, gain "built-in" to corporate assets when it converts from a C to an S corporation is taxable at the corporate level. I.R.C. § 1374.

<sup>138</sup> I.R.C. § 301.

Therefore, corporate earnings are subject to double taxation: (1) they are taxable for the corporation when earned, and (2) they are taxable for the shareholder when distributed. A similar double tax is imposed when a C corporation distributes appreciated property; the transaction is treated as if the corporation sold the property for its value and distributed the cash proceeds to the shareholder.<sup>139</sup>

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<sup>139</sup> I.R.C. §§ 311, 312.