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[a] Rev. Rul. 74-44. In addition to these economic considerations, the tax practitioner should also analyze the tax consequences of making distributions to the corporation's shareholders. In Rev. Rul. 74-44, two shareholders of an S corporation withdrew *no salary* from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed. This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and Federal Unemployment Tax Act ("FUTA") purposes (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Rev. Rul. 74-44 clearly indicates that the payment of *no* compensation will be unreasonable where shareholder-employees provide substantial services to the corporation. 26

[b] *Radtke, Spicer Accounting*. In *Radtke v. United States,* the court recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, where the shareholder made all of his withdrawals from the S corporation in the form of S corporation distributions and received *no salary* from the S corporation during the tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in *Spicer Accounting, Incorporated v. United States,* the court recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes where the shareholder received *no salary* during the tax year. 26

[c] *Esser*. Additionally, in *Fred R. Esser, P.C. v. United States,* the court recharacterized amounts received by the sole shareholder, officer and director of a legal services S corporation, as wages subject to FICA and FUTA taxes, rather than as distributions. As in the *Radtke* and *Spicer Accounting* cases, the shareholder received *no salary* from the S corporation during the tax year. 27

[d] *Cave*. In *Donald G. Cave, A Professional Law Corp. v. Commissioner*, the court recently held that all of the non-shareholder attorneys, as well as a law clerk, of a law firm were common law employees rather than independent contractors, and also recharacterized the distributions made to the sole shareholder of the law firm, who was determined to be a statutory employee, as wages subject to Social Security taxes................................27

[e] *Watson*. In *David E. Watson P.C. v. United States*, the Eighth Circuit Court of Appeals affirmed the decision of the district court recharacterizing a significant portion of dividend distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes. 27

[f] *Herbert*. In *Herbert v. Commissioner*, the Tax Court recharacterized a portion of the amounts the taxpayer claimed were used to pay business expenses as wages subject to Social Security taxes, finding the taxpayer's salary was unreasonably low. However, the Tax Court expressly rejected the Service's contention that the taxpayer's salary be increased by $52,600, primarily based on the salary paid by the S corporation to the shareholder in a prior year in which the business was not owned by the taxpayer. 29

[g] *McClary*. In *Sean McClary Ltd., Inc. v. Commissioner*, the Tax Court recharacterized the distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes where the shareholder received no salary from the S corporation and also found that the annual compensation formula contained in the Board of Directors minutes setting a salary of $24,000 was unreasonably low. 29

[h] *Glass Blocks*. In *Glass Blocks Unlimited v. Commissioner*, the Tax Court recharacterized the total distributions made by an S corporation to its president, sole shareholder and only full-time employee, of $30,844 in 2007 and $31,644 in 2008, as wages subject to Social Security taxes. 30

[i] Observation. The *Watson* case, the *Herbert* case and the *McClary* case are the first reported decisions in which the court was presented with a situation which was not clearly abusive such as those presented in *Radtke* and *Spicer Accounting* (i.e, where ***all*** of the earnings of the S corporations were paid to the sole shareholder as dividend distributions and no salary was paid to the shareholder by the S corporation). The *Watson, Herbert,* and *McClary* cases likewise involve situations where only a portion of amounts not treated as wages are recharacterized as wages subject to Social Security taxes, ***and each involves different methods in determining what constitutes "reasonable compensation" to the shareholder-employees of an S corporation***. Consequently, the *Watson, Herbert* and McClary decisions represent important victories for the IRS in being able to recharacterize dividend distributions as wages where at least some (but less than a reasonable) salary has been paid to the shareholder-employees of the S corporation. On the other hand, these

cases can be viewed as favorable to taxpayers as they allowed personal service S corporations to distribute significant amounts of their income ***without*** being subject to Social Security taxes. However, the *Watson* case is somewhat troubling in its rejection of the decision reached in the *Pediatric Surgical Associates*, *P.C.* case (in which the IRS sought to recharacterize wages of a C corporation as dividend distributions rather than vice versa), in that the court did not seem to take into account the fact that dividend distributions can indeed be generated by the services of nonshareholder-employees of an S corporation or from other ancillary services not provided by the shareholder-employees of the S corporation.31

[j] Abusive versus Non-Abusive Situations. The *Radtke, Spicer Accounting* and *Esser* cases indicate that in ***abusive situations***, such as ***where the shareholders*** of an S corporation make all withdrawals from the S corporation in the form of S corporation distributions and ***receive no salary from the S corporation*** during the tax year, the courts can and will recharacterize such distributions as wages subject to Social Security taxes. These earlier cases have been followed in more recent cases. 31

[k] IRS Fact Sheet FS-2008-25. In IRS Fact Sheet FS-2008-25, the IRS clarified information that small business taxpayers should understand regarding the tax law for corporate officers who perform services for S corporations. In the Fact Sheet, the IRS points out that just because an officer is also a shareholder of the S corporation, it does not change the requirement that payments to the corporate officer must be treated as wages, and that courts have consistently held that S corporation officer-shareholders who provide more than minor services to the corporation and who receive or are entitled to receive payments are employees whose compensation is subject to federal employment taxes. 32

[l] *PMTA 2017-005*. In *PMTA 2017-005* (March 30, 2017), the IRS determined that the Tax Court does not have jurisdiction under Section 7436 to review a determination that a corporation is liable for additional employment taxes due to the IRS's recharacterization of payments made to, or on behalf of, corporate officers who were treated as employees. 33

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[a] In General. One of the non-tax advantages, in some jurisdictions, of operating as an LLC rather than a corporation for state law purposes, is the ability of the business owners to contract around the so called duty of loyalty. This is important where business owners are engaging in multiple businesses or lines of business, through the use of multiple business entities. Another frequent scenario that gives rise to this issue is when multiple existing businesses form an entity as a joint venture but wish to engage in the same or a similar business as the joint venture. Often the same individuals who manage the joint venture also manage one of the joint venture partners. A non-tax issue that is often overlooked when forming a business entity is whether participating in a business, as a manager, member, partner or director, can preclude one from participating in another business which engages in the same or a similar line of business. The problem arises out of the historic "corporate opportunity doctrine" which is based on a director's and an officer's duty of loyalty to the corporation. It is important to deal in advance with the issues of corporate or business opportunity. 52

[b] Corporate Opportunity Doctrine. The corporate opportunity doctrine has been defined as follows by the Delaware courts: If there is presented to a corporate officer or director a business opportunity which (i) the corporation is financially able to undertake, (ii) is, from its nature, in the line of the corporation's business and is of practical advantage to it, and (iii) is one in which the corporation has an interest or a reasonable expectancy, and by embracing the opportunity, the self-interest of the officer or director, will be brought into conflict with that of the corporation, the law will not permit him to seize the opportunity for himself. The Court in *Cellular Information Systems, Inc. v. Broz*quoting *Guth v. Loft, Inc.*,went on to state as follows: 53

[c] Different State Laws. Different states have different tests that apply to determine theft of corporate opportunity, thus the laws of the relevant state should be reviewed. 53

[d] Corporations. 53

[e] Business Purpose Clause. One way to deal with the issue of theft of business opportunity is to narrowly define the "purposes" clause in the articles of incorporation (for a corporation) or the articles of organization for an LLC. If the purpose of the entity is narrowly defined, this would make it harder for someone to argue that a particular opportunity was an opportunity of the entity in question. A limited "purposes" clause would, however, limit the freedom of the entity to engage in a variety of activities and make an ultra vires attack easier if the entity was engaging in activities outside that limited scope. 54

[f] Fiduciary Duties Often Not Waivable. Where a state LLC statute limits the ability of an LLC's organic documents to eliminate or reduce by

agreement certain fiduciary duties that a manager or member may owe to an LLC or its members, the inability to limit such fiduciary duties may become problematic if a member or manager of an LLC is given an opportunity to participate in a business, where such participation might violate such fiduciary duties. 54

[g] Delaware LLCs. A potential solution to the problem mentioned in § 19.02[3][f] would be to look to Delaware LLC law. The Delaware LLC Act provides that "it is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." 6 Delaware Code 18-1101(c), which was amended in 2013, goes on to provide as follows:....................54

[h] Drafting Issues. It is important to draft the agreements to clearly reflect the parties' intentions on how far the parties should be able to go in terms of competition with the entity. If the parties want to be able to compete with the entity in which they are owners or in management, then they should expressly provide for such competition. They may also want to consider the issues of self-dealing and set forth whether this is allowed or not allowed. Because the Delaware courts are allowing this flexibility in terms of LLCs and LPs, it would be advisable to take advantage of this freedom and spell out as clearly as possible what the parties can and cannot do in terms of corporate opportunity and self-interested transactions. 56

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[b] Corporate Formalities. With respect to businesses operated as S corporations for tax purposes, practitioners have normally used state law corporations formed under some version of the Model Business Corporation Act (MBCA). Alabama's version of the MBCA requires an Alabama corporation to follow various corporate formalities in the manner in which the corporation is operated. Alabama Code Section 10-2B-8.01 provides that the management of a corporation is performed by a board of directors, which represents the interest of passive shareholders and both the directors and the shareholders. Such groups act through the formality of holding of meetings or by the unanimous written consent of such bodies. Corporate bylaws or applicable statutory provisions require certain amounts of notice prior to a meeting being held and for specific quorums to be present before actions can be taken. It is these types of formalities that can result in an attempt by creditors of the entity to pierce the entity's corporate veil. 59

[c] LLC Formalities. By comparison to the MBCA, the LLC acts of the various states allow for much greater flexibility in the manner in which LLCs are operated. For instance, Alabama's Limited Liability Company

Act may be managed by its members or may have managers who are separate from the members. Moreover, actions by Alabama LLCs do not require formal meetings or that formal notice requirements be followed. In fact, the Alabama LLC Act does not mandate that the members and managers meet at least annually, which is required of Alabama corporations. While decisions are often documented by formal written consents of the Members or the Managers, Alabama LLCs are not required to follow the formalities mandated for Alabama corporations. 59

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[i] The Howell Case. 69

[j] The Riether Case. 70

[k] CCA 201436049. 71

[l] CCA 201640014. In CCA 201640014, the IRS rejected the claim of a member of an LLC, who was involved in the management of the LLC's business, that a portion of the member's share of profits of the LLC was not subject to self-employment taxes under the limited partner exclusion of IRC Section 1402(a)(13). 73

[m] Hardy. In *Hardy v. Commissioner*, the court determined that Dr. Hardy's minority interest in a limited liability company operating a surgery center did not have to be grouped with his activity as a plastic surgeon and that the net income from the surgery center was passive and could be offset by

Dr. Hardy's other passive losses for purposes of IRC Section 469. Further, the court held that although he performed surgeries at the surgery center, his distributive share of income qualified for the "limited partner" exclusion for net earnings from self-employment under IRC Section 1402(a) (13). 74

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[4] The Framework eliminates most itemized deductions, but retains tax incentives for home mortgage interest and charitable contributions. 103

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[6] Estate tax and generation skipping transfer tax would be repealed. The Framework does not mention whether the gift tax would also be repealed. The Framework also does not mention a new "death capital gains tax" or whether there would be a stepped up bais or carryover basis...103

[7] As for changes that will impact closely-held businesses, the following proposed major changes appear in the Framework: 104

[a] Business income" from pass-through entities and sole proprietors will have a tax rate that is capped at a 25% tax rate. The Framework contemplates that measures will be adopted to prevent the recharacterization of "personal" income into "business" income to prevent wealthy individuals from avoiding the top personal tax rate. Tax rate for C corps would drop to 20%. 104

[b] There are lots of questions surrounding what will constitute "business" versus "personal" income and whether the current "reasonable compensation" standard used in the S corporation area for determining whether distributions should be recharacterized as wages for social security tax purposes would be applied. Given the definitional issues at hand, it's easy to imagine a slew of new regulations, IRS challenges, and court cases that would arise over the question of what is considered to be "reasonable" compensation and/or "personal" versus "business" income.104

[8] Under the Framework, all U.S. businesses would be permitted to immediately expense investments in all tangible and intangible assets, except structures. 104

[9] The deduction for interest expense incurred by C corporations will be partially limited. 104

[10] The current law domestic production (Section 199) deduction will be eliminated.104

1.01 INTRODUCTION.

The general trend under current tax law is to form new entities as LLCs, partnerships, S corporations or other forms of pass-through entities (including REITS), rather than as C corporations, and to convert existing C corporations to S corporation status whenever possible. Despite this trend, a significant number of professional and other service corporations are still being formed as C corporations and preexisting service corporations have remained C corporations rather than converting to S corporation status.

Many professional and other personal service corporations have remained C corporations based on the assumption that they can successfully avoid the double tax on earnings to which C corporations are generally subject by utilizing the strategy of zeroing out their taxable income by payment of all or substantially all of their earnings as deductible compensation to their shareholder-employees, and on the premise that such corporations can avoid payment of double tax on the sale of their assets by allocating the bulk of the sales proceeds to "personal goodwill." Both of these tax avoidance mechanisms are questionable, in light of recent cases in the reasonable compensation area emphasizing the independent investor test (as well as prior decisions of the Tax Court in *Pediatric Surgical Associates, P.C. v. Commissioner*[1] and *Richlands Medical Association v. Commissioner*,[2] and a number of recent cases where the courts have denied allocations to personal goodwill on the sale of professional practices, which will be discussed below.

This outline will examine the choice of entity decision based upon current law, including developments in the reasonable compensation area, the self-employment tax area and the recent legislation making permanent the 100% exclusion under Section 1202 of the Internal Revenue Code of 1986 (the "Code")[3] on certain sales of C corporation stock.

The outline will discuss how the general advantages and disadvantages applicable to each type of entity translates when applied to specific types of business, such as general operating businesses, professional service businesses, real estate businesses where REITs are an additional option, as well as businesses expecting investment from private equity funds.

Finally, this outline will look at conversions of different entities into disregarded entities as well as the conversion of disregarded entities into other types of entities, and will address structuring parent subsidiary arrangements (LLC versus QSub, and LLC versus corporate subsidiary of C corporation).

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[1] TC Memo. 2001-81.

[2] TC Memo. 1990-660, *aff'd without published opinion*, 953 F.2d 639 (4th Cir. 1992).

[3] Unless otherwise specified, all "Section" and "§" references are to the Code and all "Regulation" and "Reg. §" references are to the Treasury regulations promulgated under the Code.

1.02 TAX RATES AND CHOICE OF ENTITY STATISTICS.

[1] Individual Income Tax Rates and Choice of Entity Statistics.

Tax Rate	**Single**	**Married Filing Joint**	**Married Filing Separate**	**Head of Household**
10%	Up to $9,275	Up to $18,550	Up to $9,275	Up to $13,250
15%	$9,276-$37,650	$18,551-$75,300	$9,276-$37,650	$13,251-$50,400
25%	$37,651-$91,150	$75,301-$151,900	$37,651-$75,950	$50,401-$130,150
28%	$91,151-$190,150	$151,901-$231,450	$75,951-$115,725	$130,151-$210,800
33%	$190,151-$413,350	$231,451-$413,350	$115,726-$206,675	$210,801-$413,350
35%	$413,351-$415,050	$413,351-$466,950	$206,676-$233,475	$413,351-$441,000
39.6%	Over $415,000	Over $466,950	Over $233,475	Over $441,000

The rates in A. above also apply to ordinary income that flows through an S corporation, LLC or partnership to its shareholders, members or partners.

[2] Corporate Income Tax Rates.

Tax Bracket	**Amounts**
15% Bracket	$0 - $50,000
25% Bracket	$50,000 - $75,000
34% Bracket	$75,000 -$100,000
39% Bracket*	$100,000 - $335,000
34% Bracket	$335,000 - $10,000,000
35% Bracket	$10,000,000 - $15,000,000
38% Bracket**	$15,000,000 - $18,333,333
35% Bracket	over $18,333,333

*The 39% tax bracket applies until the benefit of the 15% bracket and 25% bracket have been “given back” and the average rate is 34%.

**The 38% tax bracket applies until the benefit of the 34% tax bracket has been “given back” and the average tax rate is 35%.

[3] Tax Rate on Long-Term Capital Gain (Non-Corporate Taxpayers).

2017
20% maximum rate

[4] Tax Rate on Dividends (Non-Corporate Taxpayers).

2017
20% maximum rate

[5] Maximum Marginal Federal Tax Rate on a C Corporation's Income or Gain that is Distributed (or deemed distributed) as a Dividend to the Shareholders.

2017
48% maximum rate*

*Note that when taking into account the 3.8% Net Investment Income tax, the combined marginal rate increases to 50.47%.

As specified above, the maximum marginal tax rate applicable to individuals exceeds the maximum marginal tax rate applicable to corporations. As a result of the maximum marginal tax rate for individuals exceeding the maximum marginal tax rate for corporations, some commentators believe this could result in a resurgence of C corporations. However, if such C corporations desire to distribute their earnings out to their shareholders, the current 48.00% (or 50.47% when taking into account the 3.8% tax on Net Investment Income) maximum marginal combined tax rate applicable to corporations and shareholders should be enough of an incentive for such corporations to be formed as, or to remain, pass-through entities,. Additionally, C corporations, unlike pass-through entities, will still be subject to double taxation on the sale of their assets.

[6] Choice of Entity Statistics.

Although LLCs have gained increasing popularity over the last decade, the number of entities taxed as S corporations still exceeds the number of entities taxed as partnerships for federal tax purposes, and it is projected to stay that way for the foreseeable future, as set forth in the table below published by the IRS:[4]

[4] Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2016-2023, Rev. 6/2016.

Statistics Regarding Choice of Entity

	2016 (Actual)	**2018 (Projected)**	**2021 (Projected)**	**2024 (Projected)**
Form 1065	4,005,907	4,173,700	4,414,500	4,596,500
Form 1120S	4,831,588	5,007,900	5,247,800	5,423,100
Form 1120	1,807,102	1,750,100	1,661,100	1,576,600

1.03 SPECIAL RULES APPLICABLE TO PERSONAL SERVICE CORPORATIONS.

Although the Code does not define the term "professional corporation" or "service corporation," it does define the term "personal service corporation" for a variety of purposes. A corporation may be classified as a personal service corporation for purposes of determining: the taxable year of a corporation under Section 441(i)(1); the tax rates to which the corporation will be subject under Section 11(b)(2); the method of accounting which may be used by the corporation under Section 448; and whether the corporation will be subject to the passive activity loss rules under Section 469. Depending upon the purpose for which a corporation is being tested, the definition of what constitutes a "personal service corporation" may differ. Two of the most important limitations placed upon "personal service corporations," are the flat 35% tax rate imposed on "qualified personal service corporations" under Section 11(b)(2) and the requirement that a "personal service corporation" have a "required taxable year" under Section 441(i)(1).

[1] Qualified Personal Service Corporations and the 35% Flat Tax.

C corporations are generally subject to graduated tax rates under Section 11(b)(1). Under Section 11(b)(2), however, a C corporation which is classified as a "qualified personal service corporation" is not eligible for graduated tax rates but is subject to a flat 35% tax on its taxable income. Under Section 448(d)(2), the term "qualified personal service corporation" means any corporation: (1) substantially all of the activities of which involve the performance of services in the "qualifying fields" of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; and (2) substantially all of the stock of which (by value) is held by employees performing services for such corporation in connection with activities involving a qualifying field. The Section 448(d)(2) definition of a personal service corporation is also the definition used for determining whether a C corporation may use the cash method of accounting under the personal service corporation exception found in Section 448(b)(2). Temp. Reg. § 1.448-1T(e)(4)(i) provides that substantially all the activities of a corporation will be treated as involved in the performance of a qualifying field only if 95% or more of the time spent by employees of the corporation is devoted to the performance of services in a qualifying field. Additionally, under Temp. Reg. § 1.448-1T(e)(5)(i), substantially all of the stock of a corporation will be treated as held by employees performing services for such corporation in connection with activities involving a qualifying field if such employees own 95% or more of such stock.

[2] Personal Service Corporations and the Required Taxable Year.

Under Section 441(i)(1), a personal service corporation is generally required to be on a calendar year unless it can establish a business purpose for having a different period for its taxable year. A personal service corporation may also have a taxable year other than a calendar year if it makes a Section 444 election and complies with the compensation deduction provisions of Section 280H. For purposes of the taxable year requirement, a personal service corporation is defined as a corporation meeting the following requirements:

[a] The corporation must be a C corporation.

[b] The principal activity of the corporation during the testing period must be the performance of personal services.

[c] During the testing period, the personal services must be "substantially performed" by employee-owners.

[d] Employee-owners must own more than 10% of the fair market value of the outstanding stock of the corporation on the last day of the testing period for the taxable year.[5]

The "testing period" for a taxable year is defined in Reg. § 1.441-3(c)(2) as the taxable year immediately preceding the taxable year in issue, or, in the case of a taxpayer's first taxable year, the period beginning on the first day of the taxable year and ending on the earlier of the last day of such taxable year or the last day of the calendar year in which such taxable year begins.

Reg. § 1.441-3(d) provides that any activity of the corporation involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting will be treated as the performance of personal services. Reg. § 1.441-3(e) provides that the principal activity of a corporation will be considered to be the performance of personal services if the cost of the corporation's compensation for such period attributable to its personal service activities exceeds 50% of the corporation's total compensation costs for such period. Under Reg. § 1.441-3(f)(1), personal services will be treated as substantially performed by the employee-owners of the corporation if more than 20% of the corporation's compensation costs attributable to personal service activities are attributed to personal services performed by the employee-owners.

1.04 ADVANTAGES OF OPERATING AS AN S CORPORATION OR OTHER PASS-THROUGH ENTITY VERSUS A C CORPORATION.

Set forth below is an examination of both the advantages and disadvantages of operating a corporation as an S corporation (or other pass-through entity) versus a C corporation.

[1] No Double Tax on Earnings.

Under Section 1363(a), an S corporation is generally treated as a pass-through entity and not as a taxable entity for federal income tax purposes, and as such, its shareholders are generally subject to only one level of tax on its earnings. (Section 1374, however, imposes a tax on the

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[5] Reg. § 1.441-3(c)(1).

built-in gains of S corporations that were formerly C corporations for a 5-year recognition period beginning on the date of the corporation's conversion to S corporation status. Additionally, under Section 1375, a corporate level tax is imposed on the excess net passive investment income of S corporations having subchapter C earnings and profits.) Under Section 1366(a), subject to certain limited exceptions, all items of income, loss, deduction and credit of an S corporation pass through the corporation and are taxed directly to its shareholders in proportion to their respective ownership interests in the corporation. In turn, under Section 1367, a shareholder's basis in his or her S corporation stock is increased by such shareholder's proportionate share of the income of the S corporation and decreased by such shareholder's proportionate share of the losses of the S corporation as well as by distributions of cash and property to such shareholder to the extent such distributions are received tax-free. As a general rule, distributions of cash and/or property to an S corporation shareholder may be received tax-free by the shareholder to the extent of the shareholder's basis in his or her S corporation stock.[6] To the extent that distributions exceed a shareholder's basis in his or her stock, however, the excess is generally treated as capital gain.[7]

The rules applicable to partnerships are similar but even more flexible and don't involve any taxes imposed at the entity level.

Because S corporations and other pass-through entities are by their nature generally subject to only one level of tax, such entities need not pay out large amounts of compensation in order to reduce their taxable income to zero as does a C corporation. Consequently, an S corporation is not subject to traditional unreasonable compensation arguments to which C corporations are susceptible. S corporations may, however, be subject to unreasonable compensation arguments in at least three situations. First, under Section 1366(e), the IRS is expressly authorized to recharacterize S corporation distributions as wages of a particular shareholder where such shareholder is a member of the family of one or more of the other shareholders and has rendered services for the corporation without receiving reasonable compensation for such services. Second, the IRS has successfully recharacterized S corporation distributions as wages subject to social security taxes where wages have been set at an unreasonably low level.[8] Lastly, the reduction of an S corporation's taxable income for purposes of minimizing the built-in gains tax by means of the payment of excessive compensation could prompt the IRS to use unreasonable compensation arguments in this context.

Unlike S corporations and other pass-through entities, the earnings of C corporations are subject to two levels of tax, once at the corporate level and again at the shareholder level when such earnings are distributed to the shareholders as dividends. Although the maximum tax rate on dividends is only 20%, the after-tax earnings of a C corporation distributed to the corporation's shareholders as dividends are still subject to double taxation at a higher tax rate

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[6] Section 1368(b)(1).

[7] Section 1368(b)(2).

[8] See *Radtke v. U.S.*, 712 F. Supp. 143, 89-2 USTC ¶9466 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196, 90-1 USTC ¶50,113 (7th Cir. 1990); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 80, 91-1 USTC ¶50,103 (9th Cir. 1990); *C.D. Ulrich, Ltd. v. U.S.*, 692 F. Supp. 1053, 88-1 USTC ¶9318 (D. Minn. 1988); *Van Camp and Brennion v. U.S.*, 251 F.3d 862, 2001-1 USTC ¶50,446 (9th Cir. 2001); *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 TC 14 (2001); *Old Raleigh Realty Corp. v. Commissioner*, TC Summ. Op. 2002-61; and *David E. Watson P.C. v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).

than if the corporation were an S corporation or other pass-through entity and the earnings were subject to a single level of tax at the shareholder, partner or member level. The difference in tax rates will be even more pronounced in states that impose corporate income taxes on C corporations but not on S corporations, such as Florida.

In the professional corporation context, however, the double tax on corporate earnings to which most C corporations are subject has not been viewed as an advantage of S corporations over C corporations because of the strategy employed by professional corporations of bonusing out sufficient amounts of compensation to the professional corporation's shareholder-employees to reduce the corporation's taxable income to zero. Consequently, a professional corporation using the strategy of zeroing out its taxable income will not be subject to any tax at the corporate level, but rather, its shareholders will be subject to tax on the corporation's income at the maximum marginal individual tax rate, the same as if the corporation were an S corporation. As will be discussed immediately below, however, recent cases have subjected professional corporations to double tax on their earnings, based upon unreasonable compensation arguments.

[a] In Brinks *Gilson & Lione, P.C. v. Commissioner*,[9] the Tax Court once again applied the independent investor test to recharacterize compensation paid by a professional corporation, a law firm, to its shareholder-employees as nondeductible dividend distributions, and held the corporation liable for accuracy-related penalties for mischaracterizing the dividends as deductible compensation.

[i] Facts of Case. The taxpayer was an intellectual property law firm organized as a C corporation which used the cash basis of accounting. During the years in issue, the taxpayer employed about 150 attorneys, of whom about 65 were shareholders, and also employed a non-attorney staff of about 270.

Each shareholder-attorney of the taxpayer acquired his or her shares at a price equal to their book value and is required by agreement to sell his or her shares back to the taxpayer at a price determined under the same formula upon terminating his or her employment. Subject to minor exceptions related to the firm's "name partners," each shareholder-attorney's proportionate ownership of taxpayer's shares ("share-ownership percentage") equals his or her proportionate share of compensation paid by the taxpayer to its shareholder-attorneys. For the years in issue, the board of directors of the taxpayer set the yearly compensation to be paid to shareholder-attorneys and then determined the adjustments in the shareholder-attorneys' share-ownership percentages necessary to reflect changes in proportionate compensation. These adjustments in share ownership were effected by share redemptions and reissuances.

For at least 10 years prior to and including the years in issue, the taxpayer did not pay any dividends to its shareholders. In late November or early December of the year preceding the compensation year, the taxpayer's board meets to set the amount available for all shareholder-attorney compensation for that year, set compensation and share-ownership percentages. Because the board's estimate of the amount available for compensation-year payments to shareholder-attorneys is only an estimate, each shareholder-attorney receives during the course of the compensation year only a percentage of his or her expected compensation (draw), with the expectation of receiving an additional amount (year-end bonus) at the end of the year. The board

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[9] TC Memo 2016-20.

intended the sum of the shareholder-attorneys' year-end bonuses to reduce the taxpayer's book income to zero. With limited exceptions for certain older, less active attorneys, shareholder-attorneys shared in the bonus pool in proportion to their draws (and, likewise, in proportion to their share-ownership percentages). For each of the years in issue, 2007 and 2008, the taxpayer calculated the year-end bonus pool for 2007 to be $8,986,608 and for 2008 to be $13,736,331, which equaled its book income for the year after subtracting all expenses other than the bonuses.

The taxpayer treated as employee compensation the total amounts paid to its shareholder-attorneys, including the year-end bonuses. The taxpayer used an independent payroll processing firm to prepare Forms W-2 for 2007 and 2008 to its shareholder-employees, which Forms W-2 were then forwarded to its accountant, McGladrey and Pullen (McGladrey).

The taxpayer had invested capital, measured by the book value of its shareholders' equity, of approximately $8 million at the end of 2007 and approximately $9.3 million at the end of 2008. Although the taxpayer's expert witness opined at trial that clients base hiring decisions on the reputations of individual lawyers rather than those of the firms at which they practice, the expert did admit that a firm's reputation and customer list could be very valuable entity-level assets.

The taxpayer's return had previously been audited for 2006, and resulted in a "no change" letter. However, when the IRS audited the taxpayer for 2007 and 2008, the year-end bonuses that the taxpayer paid to its shareholder-attorneys were disallowed as nondeductible dividend distributions. After negotiations, the parties entered into a closing agreement providing that portions of the taxpayer's compensation deductions to its shareholder-employees for the years in issue, $1,627,000 in 2007 and $1,859,000 in 2008, should be disallowed and recharacterized as nondeductible dividends. Consequently, the only issue remaining for decision was whether the taxpayer was liable for accuracy-related penalties on underpayments of tax relating to amounts deducted as compensation that it conceded were nondeductible dividends.

[ii] Accuracy-Related Penalties. Section 6662(a) and (b)(1) provide for an accuracy-related penalty of 20% of the portion of an underpayment of tax attributable to negligence or disregard of rules and regulations. Section 6662(a) and (b)(2) provide for the same penalty on the portion of an underpayment of tax attributable to "any substantial understatement of income tax." Section 6662(d)(2)(A) defines the term "understatement" as the excess of the tax required to be shown on the return over the amount shown on the return as filed. In the case of a corporation, an understatement is substantial if it exceeds the lesser of: (1) 10% of the tax required to be shown on the return for the tax year, or (2) $10 million. An understatement is reduced, however, by the portion attributable to the treatment of an item for which the taxpayer has "substantial authority."[10] Additionally, Section 6664(c)(1) provides an exception to the imposition of the Section 6662(a) accuracy-related penalty if it is shown there was "reasonable cause" for the underpayment and the taxpayer acted in good faith.

Although the taxpayer did not dispute that the deficiency to which it has agreed for the years in issue exceeds 10% of the agreed income tax it was required to show on its returns for such years, the taxpayer argued that it has substantial authority for deducting in full the year-end bonuses paid to its shareholder-attorneys. In addition, the taxpayer argued that because it relied

[10] Section 6662(d)(2)(B)(i).

on the services of a reputable accounting firm to prepare its returns for the years in issue, it had reasonable cause to deduct those amounts and acted in good faith in doing so.

[iii] Substantial Authority. The Tax Court's analysis of whether the taxpayer had substantial authority for its position provides valuable insight as to the Tax Court's current position on the ability to recharacterize wages paid to shareholder-employees of professional corporations as nondeductible dividend distributions. Specifically, the IRS claimed that the amounts paid to the shareholder-employees of the corporation did not qualify as deductible compensation to the extent the payments were funded by earnings attributable to the services of non-shareholder employees or to the use of the corporation's intangible assets or other capital. Rather, amounts paid to shareholder-employees that are attributable to such sources must be characterized as nondeductible dividends. In support of its position, the IRS relied primarily on its opinion in *Pediatric Surgical Associates v. Commissioner,*[11] and the recent decision by the Seventh Circuit Court of Appeals in *Mulcahy*,[12] both of which are discussed below.

[iv] Independent Investor Test. Much of the Tax Court's decision addressed the application of the "independent investor test" in determining the deductibility of compensation paid by a C corporation to its shareholder-employees. As discussed below, *Mulcahy* was the first case in which the court applied the independent investor test to a professional services corporation. The Tax Court stated that well before the years in issue, an increasing number of Federal Courts of Appeal, including the Court of Appeals for the Seventh Circuit, were moving away from a multi-factor analysis in assessing the deductibility of amounts paid as compensation to shareholder-employees and focusing on the effect of the payments on the returns available to the shareholders on their capital.[13] Under the independent investor test, the courts consider whether payments made as salary to shareholder-employees meet the standards for deductibility by taking the perspective of a hypothetical "independent investor" who is not an employee. In essence, the test provides that if the corporation's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the corporation as disguised salary. Consequently, ostensible compensation payments made to shareholder-employees by a corporation with significant capital that zeroes out the corporation's income and leaves no return on the shareholders' investment fails the independent investor test.

The Tax Court found that the taxpayer had substantial capital even without regard to any intangible assets based on the shareholders' equity of $8 million at the end of 2007 and $9.3 million at the end of 2008. The Tax Court found that investor capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder-employees is really a distribution of earnings. Consequently, the Tax Court concluded that the taxpayer's practice of paying out year-end bonuses to its shareholder-employees that eliminated its book income failed the independent investor test.

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[11] TC Memo 2001-81.

[12] 680 F.3d 867 (7th Cir 2012), *aff'g* TC Memo 2011-74, (affirming the Tax Court's decision).

[13] See *Exacto Spring Corp v Commissioner*, 196 F.3d 833 (7th Cir 1199), *rev'g Heitz v Commissioner*, TC Memo 1998-220; *Rapco, Inc v Commissioner*, 85 F.3d 950 (2d Cir 1996), *aff'g* TC Memo 1995-128; and *Elliotts, Inc v Commissioner*, 716 F2d 1241 (9th Cir 1983), *rev'g and remanding* TC Memo 1980-282.

The taxpayer argued that Section 83 and its accompanying regulations, dealing with transfers of property in connection with the performances of services, as well as the fact that the shareholder-employees acquired their stock at a price equal to its cash book value and must sell their stock back to the corporation for a price determined under the same formula upon terminating their employment, suggests that its shareholder-attorneys lack the normal rights of equity owners, and as such, that the independent investor test should not apply in their case. The Tax Court specifically rejected both of these arguments and stated the following:

More generally, petitioner's argument that its shareholder-attorneys have no real equity interest in the corporation that would justify a return on invested capital provides too much. If petitioner's shareholder-attorneys are not its owners, who are? If the shareholder-attorneys do not bear the risk of loss from declines in the value of the assets, who does? The use of book value as proxy for fair market value deprives the shareholder-attorneys of the right to share in the unrealized appreciation upon selling their stock -- although they are correspondingly not required to pay for unrealized appreciation upon buying the stock. Acceptance of these concessions to avoid difficult valuation issues does not compel the shareholder-attorneys to forego, in addition, any current return on their investments based on the corporation's profitable use of its assets in conducting its business. Petitioner's arrangement effectively provides its shareholder-attorneys with a return on their capital through amounts designated as compensation. Were this not the case, we do not believe the shareholder-attorneys would be willing to forego any return on their investments.

The Tax Court then went on to refute the argument made by the taxpayer in the *Law Offices-Richard Ashare, P.C. v. Commissioner*[14] case, in which the Tax Court did allow the taxpayer to deduct compensation that exceeded the corporation's revenue for the years in issue, which established the principal that a law firm with significant capital can pay out compensation that eliminates book income. The Tax Court pointed out that the taxpayer in the *Ashare* case did not consistently pay compensation that had the intended effect of eliminating book income and that the shareholder had invested only minimal capital in the corporation ($1,000).

The Tax Court then went on to reject the taxpayer's purported authorities that establish that capital is not a material income producing factor in a professional services business because the cases cited by the taxpayer did not address the deductibility of compensation paid to shareholder-employees.[15] The Tax Court expressly stated that these authorities do not support the proposition that a corporation with substantial capital can pay deductible compensation to its shareholder-employees in amounts that leave no return to the shareholders on their investments in the corporation.

Finally, the Tax Court readily dismissed the taxpayer's claim that the portion of the year-end bonuses determined to be nondeductible as compensation should nonetheless have been deductible as interest based on the taxpayer's claim that its stock was really debt.

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[14] TC Memo 1999-282.

[15] See, eg, *Hubbard-Ragsdale Co v Dean*, 15 F2d 410 (SD Ohio 1926), *aff'd per curiam*, 15 F2d 1013 (6th Cir 1926); Reg. § 1.704-1(e)(1)(iv); and Reg. § 1.1361-2(e)(2) (prior to its removal by TD 8104, 1986-2 CB 153).

In concluding that the taxpayer did not have substantial authority for its position, the Tax Court again reiterated that the independent investor test weighs strongly against the claimed deductions.

[v] Reasonable Cause and Good Faith. The Tax Court then addressed the taxpayer's argument that it had reasonable cause for its position and acted in good faith. Specifically, the taxpayer alleged that its reliance on McGladrey to prepare its returns for the years in issue constituted reasonable cause and demonstrated good faith. The Tax Court found that the taxpayer's argument failed for two reasons.

First, the record provides no evidence that McGladrey advised petitioner regarding deductibility of the year-end bonuses. Second, in characterizing the compensation for services amounts that have been determined to be dividends, the taxpayer failed to provide McGladrey with accurate information. The court also rejected the taxpayer's argument that the "no-change" letter it received at the conclusion of the audit of its 2006 return was sufficient to establish reasonable cause and good faith.

The Tax Court concluded that the taxpayer consistently followed a system of computing year-end bonuses that disregarded the value of its shareholder-attorneys' interest in the capital of the firm and inappropriately treated its compensation amounts that eliminated the firm's book income. Specifically, the Tax Court stated that "Although petitioner offered no evidence as to why it adopted its practice of paying year-end bonuses, it is difficult to imagine reasons that are not tax related."

[b] *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*. In Mulcahy, Pauritsch, Salvador & Co. v. Commissioner,16 the Seventh Circuit Court of Appeals affirming the Tax Court, held that over $850,000 paid in each of the three years in issue to entities owned by each of the founding shareholders of an accounting firm operated as a C corporation should be recharacterized as nondeductible dividend distributions. The Mulcahy case represents the first case in which a court has applied the so-called "independent investor test" in determining reasonable compensation in the professional service corporation setting.

Under the facts of the case, an accounting firm operated as a C corporation, had 40 employees located in multiple branches, and, according to the court, had both physical capital and intangible capital (in the form of client lists and brand equity).

Although the corporation had revenues between $5 million to $7 million annually, the corporation itself had little or no income because its gross revenues were offset by deductions for business expenses, primarily compensation paid directly or indirectly to its owner-employees, which included three of the firm's accountants whose names form the name of the firm and owned more than 80% of the firm's stock (the "Founding Shareholders"). The firm reported taxable income of only $11,279 in 2001, a loss of $53,271 in 2002 and zero taxable income in 2003. In addition to the salaries received by the Founding Shareholders that totaled $323,076 in 2001, the corporation additionally paid more than $850,000 in "consulting fees" for each of the three years in issue to three entities owned by the Founding Shareholders, which in turn distributed the money to the Founding Shareholders.

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[16] 680 F.3d 867 (7th Cir 2012), *aff'g* TC Memo 2011-74.

The IRS did not question the salary deductions, but disallowed the consulting fees paid to the three entities owned by the Founding Shareholders as nondeductible dividends, resulting in a deficiency in corporate income tax of more than $300,000 for each of the three years in issue.

As will be discussed in more detail below, the Seventh Circuit found that the accounting firm would flunk the independent-investor test if it were to treat the consulting fees as salary expenses, since they reduced the firm's income such that the return to a hypothetical equity investor of the corporation would be zero or below zero.

In its decision, the Seventh Circuit found that although the independent investor test may not be applicable to the "typical small professional services firm," the accounting firm in issue was not a very small firm because of its physical capital, numerous employees and intangible capital. Consequently, as stated above, the Seventh Circuit found that the Tax Court was correct to reject the firm's argument that the consulting fees were salary expenses because treating such expenses as salary reduced the firm's income, and thus the return to the hypothetical equity investor, to zero or below zero. The Seventh Circuit specifically found that there was no evidence that the "consulting fees" were compensation for the Founding Shareholders' accounting and consulting services, but rather were nondeductible dividend distributions.

The court specifically rejected the firm's argument that since the consulting fees were allocated among the Founding Shareholders in proportion to the number of hours that each of them worked, rather than their stock ownership, those fees could not have been dividends. The court stated that whatever the method of allocation of the firm's income (in accordance with stock ownership or otherwise), if the fees were paid out of corporate income—if every compensated hour included a capital return, the firm owed corporate income tax on the net income hiding in those fees and specifically stated that "a corporation cannot avoid tax by using a cockeyed method of distributing profits to its owners."[17]

The court went on to state that "remarkably, the firm's lawyers (*an accounting firm's lawyers*) appear not to understand the difference between compensation for services and compensation for capital … ." The court also noted its puzzlement that the firm chose to organize as a conventional business corporation in the first place, and scathingly concluded by stating "That an *accounting firm* should so screw up its taxes is the most remarkable feature of the case."

As demonstrated by the *Brinks* case and the *Mulcahy* case, it is very difficult, if not impossible, for most professional corporations to meet the independent investor test where the professional corporation distributes all or substantially all of its income in the form of compensation to its shareholder-employees (in which case the return for the independent investor would be 0%). The *Brinks and Mulcahy* cases represent yet another tool in the Service's arsenal for attacking compensation paid to the shareholder-employees of a professional services corporation. In addition, the Service has the ability to attack compensation paid to the shareholders of a professional services corporation based on the compensatory intent prong of Treasury Regulations Section 1.162-7(a), as demonstrated by *Richlands Medical Association v.*

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[17] See also, *Kennedy v Commissioner*, 671 F2d 167 (6th Cir 1982), *rev'g and remanding* 72 TC 793 (1979), where the court found that the fact that compensation payments are not made in proportion to the shareholder-employee's stock ownership does not preclude a finding that the compensation payment actually constituted a dividend.

Commissioner,[18] and *Pediatric Surgical Associates, P.C. v. Commissioner*,[19] discussed below. The *Brinks* case should send a strong message to mid-size to large personal service corporations operating as C corporations that the courts can and will recharacterize wages as nondeductible dividends where the professional corporation's normal practice is to zero out all income by payment of compensation to its shareholder-employees.

[c] *Pediatric Surgical Associates*. In *Pediatric Surgical Associates, P.C. v. Commissioner*,[20] the Tax Court recharacterized a portion of the amounts paid as wages to the shareholder-employees of a C corporation conducting a medical practice as non-deductible dividend distributions.

Under the facts of the case, the taxpayer was a personal service corporation which, through its surgeon-employees, provided pediatric surgical services to its patients. The taxpayer used the cash method of accounting and had never declared a dividend to any of its shareholders. During the years in issue, the taxpayer employed approximately twenty individuals, including six pediatric surgeons. The shares of stock of the taxpayer were owned exclusively by individuals who were employed by the taxpayer as surgeons. From January 1, 1994 through June 30, 1995, the shareholders were Drs. Ellis, Mann, Miller and Black, and from July 1, 1995 to December 31, 1995, the shareholders were all of such doctors except Dr. Ellis, who ceased to be a shareholder on June 30, 1995.

Under their employment contracts with the taxpayer, the shareholder-employees received a monthly base compensation, and equal bonuses on a monthly basis in amounts based on the cash in taxpayer's bank account, less cash necessary to meet anticipated cash flow needs for the immediate and near future. During the years in issue, the taxpayer also employed two surgeons who were not shareholders of the corporation. Under the Employment Agreements of the non-shareholder employees, they were paid a fixed salary and received no bonuses from the taxpayer.

The IRS sought to recharacterize that portion of the wages paid to the shareholder-employees attributable to the net profits of the non-shareholder employees (collections of non-shareholder employees less direct expenses and allocable share of overhead), as dividends. The IRS stated that Section 162(a)(1) establishes a two-prong test for the deductibility of payments purportedly paid as salaries. To be deductible as compensation for services, the payments must be: (1) reasonable; and (2) *in fact payments merely for services*. The IRS argued that the portion of the compensation paid to the shareholder-employees equal to the net profits of the non-shareholder employees did *not* constitute a payment for services rendered by such shareholder-employees, but rather constituted a non-deductible, disguised dividend.

In reaching its decision that the portion of the wages paid to the shareholder-employees attributable to the net profits of the non-shareholder employees constituted a dividend, the court rejected the argument advanced by the taxpayer that *Richlands Medical Association v. Commissioner*,[21] established a rule of law that an employer may deduct as compensation paid to an employee an amount equal to the collections received by the corporation for services performed by such employee.

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[18] TC Memo 1990-660.
[19] TC Memo 2001-81.
[20] TC Memo 2001-81.
[21] TC Memo. 1990-660, *aff'd without published opinion*, 953 F.2d 639 (4th Cir. 1992).

The *Pediatric Surgical Associates* case could have a substantial adverse impact on a number of personal service corporations (including, but not limited to, medical practices, accounting firms, and law firms). In the case of medical practices, the amounts paid to their shareholder-employees can be attributable to the net profits of associate physicians, physician assistants, nurse practitioners and ancillary revenues. In the case of law firms, a portion of the amounts paid to their shareholder-employees many times represent net profits attributable to associates and paralegals. Likewise, a portion of the amounts paid by accounting firms to their shareholder-employees are attributable to the net profits of non-shareholder staff accountants.

[d] Richlands Medical Association v. Commissioner. In *Richlands Medical Association v. Commissioner*,[22] the court disallowed a large portion of the compensation paid by a professional association engaged in the practice of medicine and in the operation of a hospital to its three physician-owners. In the two years in issue, the compensation paid to each of the physician-owners not only substantially exceeded the collections recorded for their services but also substantially exceeded the billings for them. During this time, the professional association employed eight to ten non-owner physicians who performed services at the hospital operated by the professional association and who consequently generated income for the professional association.The court held that the physician-owners were entitled to receive, as compensation for their services, 100% of the collections recorded by them as attributable to such services. The court rejected the taxpayer's argument that its prior decisions in *Klamath Medical Serv. Bureau v. Commissioner*,[23] and *McClung Hosp., Inc. v. Commissioner*,[24] established a rule of law that physicians are always entitled to compensation equal to 100% of their billings. Additionally, the court allowed a portion of the compensation paid to the physician-owners for "other medically-oriented supervisory services" and additional amounts of compensation for executive functions performed by them. The court disallowed a large portion of the compensation paid to the physician-owners for their medically oriented supervisory services, and rejected the argument that they were entitled to increased compensation because they were the major "admitters" to the hospital and generated the "majority of ancillary revenue." The court also found the professional association's practice of distributing all amounts in excess of expenses and reserves as deductible compensation to its physician-owners indicative of an intent to distribute earnings under the guise of salary.

Although *Richlands Medical Association* may be somewhat unusual, since the professional association operated a hospital as well as a professional practice, it is not uncommon for the shareholder-employees of a professional corporation to receive compensation in excess of the amount of collections for personal services actually rendered by them, such as where the professional corporation has other sources of income or the professional corporation has a number of employees who are not shareholders of the corporation. The *Richlands Medical Association* case appears to have been a precursor to the Tax Court's decision in the *Pediatric Surgical Associates* case.

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[22] TC Memo. 1990-660, *aff'd without published* opinion, 953 F.2d 639 (4th Cir. 1992).

[23] 29 TC 339 (1957), *aff'd*, 261 F.2d 842, 59-1 USTC ¶9141 (9th Cir. 1958), *cert. denied*, 359 U.S. 966 (1958).

[24] TC Memo. 1960-86.

[e] <u>*Midwest Eye Center, S.C. v. Commissioner*</u>. In *Midwest Eye Center, S.C. v. Commissioner*,[25] a personal service corporation was a non-deductible dividend distribution.Under the facts of the case, the taxpayer, a C corporation, conducted an ophthalmology surgery and care center during the tax years at issue. The taxpayer operated four locations and employed around 50 employees during the 2007 tax year. Of the 50 employees, five were physicians who could perform surgery, three were optometrists, three were nurses, two were surgical technicians, 10 were non-surgical technicians, and 15 were non-administrative employees. The remaining employees served administrative functions. The taxpayer had at least one manager at each of its four locations, a full-time billing specialist, a number of front office staff and a bookkeeper.

Dr. Ahmad was the taxpayer's president, medical director, and 100 percent shareholder. Dr. Ahmad also served as the taxpayer's chief executive officer, chief operating officer and chief financial officer. These positions required him to perform various managerial tasks, as well as being an active surgeon in the practice. In 2007, the taxpayer paid a salary of $785,000 to Dr. Ahmad, and paid a $2 million bonus via four separate checks totaling $500,000 each, payable on November 8, November 21, December 5 and December 20, 2007.

In 2007, Dr. Ahmad's workload increased because one of the taxpayer's busier surgeons quit unexpectedly in June, and the taxpayer's only other retinal specialist began to reduce her workload because she planned to begin her own practice.

The taxpayer reported a tax loss for 2007 and taxable income of $0 for 2008. The taxpayer hired a professional return preparer to aid in the preparation of its returns. The IRS argued that $1 million of the claimed bonus compensation deduction for 2007 was a disguised dividend rather than a bonus compensation. The IRS also determined that the taxpayer was liable for an accuracy-related penalty under Section 6662.

Section 162(a)(1) allows taxpayers to deduct ordinary necessary expenses, including a "reasonable allowance for salaries or other compensation for personal services actually rendered." Consequently, compensation is deductible only if: (1) it is reasonable in amount; and (2) it is paid or incurred for services actually rendered.[26] The court began by discussing the so-called "independent investor test." Under this test, if the corporation's return on equity remains at a level that would satisfy an independent investor, there is a strong indication that the compensation being paid is reasonable and that profits are not being siphoned out of the corporation as disguised salary.[27] Interestingly, both the IRS and the taxpayer stipulated that the independent investor test was not applicable to the taxpayer's case. Apparently, the taxpayer argued that it was impossible to generate a meaningful comparison of the taxpayer's business because there were no businesses sufficiently similarly situated. Because of this lack of comparability, the taxpayer contended that the independent investor test could not be applied. It is somewhat perplexing that the court did not apply the independent investor test in this case based on the recent application of the independent investor test to disallow amounts paid to the

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[25] TC Memo 2015-53.
[26] Reg. § 1.162-7(a).
[27] See Exacto Spring Corp v Commissioner, 196 F.3d 833 (7th Cir 1999); Mulcahy, Pauritsch, Salvadore & Company v Commissioner, 680 F.3d 867 (7th Cir 2012), *aff'g* TC Memo 2011-74; and Menard, Inc v Commissioner, 560 F.3d 620 (7th Cir 2009), *rev'g* TC Memo 2004-207.

shareholders of an accounting firm in the *Mulcahy* case. Additionally, the taxpayer's contention that there were no businesses similarly situated does not seem plausible and would not seem to be an impediment to applying the independent investor test. Ironically, the taxpayer in this case may have actually received a better result (i.e., had less of the bonus paid to Dr. Ahmad recharacterized as a non-deductible dividend) if it had used the independent investor test. Recent cases have used 10-20% as a reasonable rate of return on equity to the independent investor, and then "backed into" the amount of reasonable compensation as equal to the balance of the earnings of the corporation.[28]

The court then turned its attention to the reasonableness of the compensation paid by the corporation to Dr. Ahmad and provided that the taxpayer had the burden to show that the bonuses paid to Dr. Ahmad were otherwise reasonable. The taxpayer produced no evidence of comparable salaries because it argued that there were no "like enterprises" under "like circumstances" from which to draw comparisons. Rather, the taxpayer argued that Dr. Ahmad's large bonus was reasonable due to his increased workload during 2007, and the various roles that Dr. Ahmad performed, such as CEO, CFO, and COO, and the corresponding managerial duties of those positions. The court noted, however, that the taxpayer did not provide any methodology to show how Dr. Ahmad's bonus was determined in relation to those responsibilities.

Additionally, the court observed that the taxpayer did not explain how the amount of the bonus was determined and why it was divided into four payments and provided no evidence to demonstrate that the full $2 million bonus was reasonable. Consequently, the court determined because the taxpayer failed to show that the bonus constituted reasonable compensation, they did not need to reach the issue of whether it was paid or incurred for services actually rendered and recharacterized $1 million of the $2 million bonus as a non-deductible dividend distribution.

The court went on to impose the accuracy-related penalty under Section 6662(a) on the taxpayer. Section 6662(a) imposes a 20% penalty on any underpayment attributable to, among other things, negligence or disregard of rules or regulations, or any substantial understatement of income tax. Under Section 6662(d)(2)(B), the amount of the understatement is reduced to the extent it is attributable to a tax treatment for which the taxpayer had substantial authority. Substantial authority for a tax treatment exists if the weight of the authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary treatment.[29] After determining that there was a substantial understatement of income as defined in Section 6662(b)(1)(A), the court determined that the taxpayer would be liable for the accuracy-related penalty unless it could show it had reasonable cause and acted in good faith regarding the underpayment. Under Reg. §1.6664-4(b)(1), a taxpayer may establish reasonable cause and good faith by showing reliance on professional advice. A taxpayer relies reasonably on professional advice if he or she proves the following by a preponderance of the evidence:

[i] The advisor was a competent professional who had sufficient expertise to justify reliance.

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[28] See generally, Multi-Pak Corp v Commissioner, TC Memo 2010-139; Thousand Oaks Residential Care Home I, Inc v Commissioner, TC Memo 2013-10; and Aries Communications Inc v Commissioner, TC Memo 2013-97.

[29] Reg. § 6662-4(d)(3)(i).

[ii] The taxpayer provided necessary and accurate information to the advisor.

[iii] The taxpayer actually relied in good faith on the taxpayer's judgment.[30]

Because the taxpayer failed to provide any evidence about the identity of its tax return preparer, the information it provided to its tax return preparer, or whether it even relied on the preparer's judgment, the court determined that the taxpayer could not establish reasonable cause and good faith by showing reliance on professional advice, and as such, imposed the accuracy-related penalty under §6662a) to the extent of the understatement.

Although the *Midwest Eye Center* case may not provide reliable precedent for the IRS to assert unreasonable compensation arguments against personal service corporations formed as C corporations because the taxpayer in the *Midwest Eye Center* case failed to produce any evidence of reasonableness, professional corporations and other service corporations should be aware that they are susceptible to unreasonable compensation arguments in light of the application of the independent investor test by the Tax Court and the Seventh Circuit Court of Appeals in the *Mulcahy* case, as well as the use of the compensatory intent test to recharacterize compensation paid to the shareholder-employees of a professional service corporation as non-deductible dividends in *Pediatric Surgical Associates, P.C.* and *Richland Medical Association.*

In *Alpha Medical, Inc. v. Commissioner*,[31] the court reversed the Tax Court in finding that salary paid to key shareholders was reasonable. In reaching its decision, the court did not cite *Dexsil* in its opinion but held for the taxpayer based on its analysis of numerous factors for determining reasonableness. In so doing, the court affirmed the continued relevance of the *Mayson* factors in determining reasonableness in the Sixth Circuit.

[2] Avoidance of Double Tax on Sale or Liquidation.

The repeal of the *General Utilities* doctrine by the Tax Reform of 1986[32] has made the S corporation alternative particularly attractive for corporations which will hold appreciated property. As a general rule, the shareholders of an S corporation are subject to only one level of tax on the sale of the corporation's property or on the corporation's liquidation. C corporations and their shareholders, on the other hand, generally will be subject to a double tax on the sale of the corporation's assets or upon the corporation's liquidation. Section 336 and 331. Consequently, corporations which will be (or which are) holding real property or other substantially appreciated property, operation in S corporation form will allow such property to be subject to only a single level of tax at capital gains rates on its sale or on the liquidation of the corporation. One of the more problematic assets potentially subject to the double tax is a corporation's goodwill. While double taxation on the sale of a C corporation's assets has always been an issue for operating companies, this became an issue with respect to professional service corporations in the 1990s where many professional medical associations operating in C corporation form sold assets to physician practice management corporations at values far in

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[30] See *Neonatology Associates, PA v Commissioner*, 115 TC 43 (2000), *aff'd,* 299 F.3d 221 (3d Cir 2002).

[31] 172 F.3d 942, 99-1 USTC ¶50,461 (6th Cir. 1999).

[32] Pub. L. No. 99-514, 100 Stat. 2085 (1986).

excess of the fair market value of their tangible assets. This remains an issue today for many medical practices operated as C corporations which are now being sold to hospitals.

[a] Avoidance of Double Tax by Allocation to Personal Goodwill. C corporations have used a strategy of allocating the bulk of any sales proceeds to personal goodwill in order to avoid the double tax normally incurred on the sale of assets by a C corporation. Several recent cases suggest that the personal goodwill strategy may not always be successful.

[i] Muskat v. Commissioner. In *Muskat v. Commissioner*,[33] the First Circuit Court of Appeals rejected taxpayer's refund suit based on the taxpayer's claim that payments contractually delineated as payments for taxpayer's covenant not to compete and originally reported by the taxpayer as ordinary income, actually were payments for taxpayer's personal goodwill, taxable as capital gain.

Irwin Muskat (TP) was the CEO of JacPac Foods, Ltd., a family business. In 1993, an agreement was reached between JacPac and a subsidiary of Corporate Brand Foods America, Inc. (CBFA) for purchase of JacPac's assets for approximately $45,000,000 plus assumption of JacPac's liabilities. As part of the sale, TP entered into an employment agreement, a noncompetition agreement and a subscription agreement (under which he invested $2,000,000 in the purchaser). Under the noncompetition agreement, the purchaser agreed to pay TP $3,955,599 for a covenant not to compete over a 13 year period. The first installment of $1,000,000 was paid at closing with the remainder payable over the 13 years. These payments survived TP's death.

TP received the first installment in 1998 and reported the payment as ordinary income on his 1998 federal income tax return and paid self-employment taxes on the income. In 2002 however, TP filed an amended return for 1998 reclassifying the $1,000,000 payment as capital gain and seeking a refund of $203,434, which included $21,479 of self-employment tax. After the IRS denied TP's refund claim, he filed suit in the federal district court. The District Court denied TP's refund claim on the ground that he failed to present strong proof that the parties intended the payment to be a payment for TP's personal goodwill and denied TP's self-employment tax claim on the ground that it lacked jurisdiction over that claim because that claim was not part of TP's administrative refund claim.

Initially, the court reaffirmed the application of the "strong proof" rule in the First Circuit. Under this rule, when parties to a transaction have executed a written contract providing for allocation of sums to particular items and one party thereafter seeks to alter the written allocation, for tax purposes, the proponent must present "strong proof" that, at the time of execution of the contract, the contracting parties actually intended the payments to be compensation for something else.

The court found that TP did not produce strong proof that the contracting parties intended the challenged payment to be compensation for TP's personal goodwill. First, the court clarified that "strong proof" means that a taxpayer's evidence must approach "clear and convincing" evidence required to reform a written contract on the ground of mutual mistake. The court found that the district court did not clearly err in holding that TP failed to adduce such strong proof. In

[33] 103 AFTR2d 2009-666 (1st Cir. 2009).

this respect, the trial testimony revealed no discussion of TP's personal goodwill during the negotiations and none of the transaction documents, including early drafts of those documents, mentioned TP's personal goodwill. Further, the court found it significant that the noncompetition agreement referenced protection of JacPac's goodwill (purchased by purchaser for $16,000,000, which made it extremely unlikely that the contracting parties intended the payments under the noncompetition agreement to serve as de facto compensation for TP's personal goodwill.

The court rejected TP's argument that survivability of the noncompetition payments mandated a conclusion that the payments were for something other than refraining from competition. The court stated that other courts have classified agreements that contain survivability provisions as valid noncompetition agreements for tax purposes.

The court also rejected TP's argument that the terms of his employment and subscription agreement were so lucrative that they eliminated any realistic possibility that, at an advanced age, TP would compete with the purchaser. The court responded that proof that a written allocation does not have economic reality, does not in of itself, constitute strong proof that the parties intended some other allocation. Further, the court found that there was evidence that the noncompetition provisions were grounded in economic reality, including the fact that CBFA representatives testified that the noncompetition agreement was to prevent the possibility that TP would use his relationships with customers, suppliers and distributors to pursue competitive opportunities.

Finally, the court upheld the district court's rejection of TP's self-employment tax claim on the ground that it lacked subject matter jurisdiction over the claim. In this respect the court agreed that TP had substantially varied the legal theory and factual basis of his self-employment refund claim made to the IRS. TP's refund claim to the IRS was based on the argument that he had incorrectly characterized the claim as ordinary income and not capital gain. However, at trial, TP shifted gears and argued that sums paid in consideration of a covenant not to compete are not deemed to have been earned in the conduct of a trade or business and, thus, are not subject to self-employment tax. The court concurred with the district court that the taxpayer's refund claim filed with the IRS did not properly raise the revised self-employment tax claim and thus, was not within the subject matter jurisdiction of the court to address.

[ii] Howard v. United States. In *Howard v. United States*,[34] the Ninth Circuit Court of Appeals affirmed the district court's denial of the taxpayer's motion for a summary judgment and granting of the government's motion for summary judgment in finding that goodwill in connection with the sale of a dental practice was corporate goodwill rather than personal goodwill.

Under the facts of the case, the taxpayer incorporated his practice as the sole shareholder, officer and director in 1980, and also entered into an employment agreement and a covenant not to compete with the corporation. The covenant not to compete provided that for so long as the taxpayer held any stock and for a period of three years thereafter, he would not engage in any business which was competitive to that of the corporation within 50 miles of Spokane, Washington. In 2002, the taxpayer and his corporation sold the practice to another personal

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[34] 108 AFTR2d 2011-5993 (9th Cir. 2011).

service corporation. In the Asset Purchase Agreement, the taxpayer was allocated $549,900 for his "personal goodwill" and $16,000 for consideration regarding a covenant not to compete with the acquiring personal service corporation. The selling corporation itself received $47,100 for its assets.

Following an audit by the IRS, the IRS recharacterized the sale of goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the acquiring personal service corporation as a dividend from the selling professional service corporation to the taxpayer. The government argued that the goodwill was corporate goodwill versus personal goodwill for three main reasons. First, the goodwill at issue was a corporate asset because the taxpayer was an employee of the corporation and had a covenant not to compete with the corporation. Second, the corporation earned the income and correspondingly earned the goodwill. Third, attributing the goodwill to the taxpayer would not comport with the economic reality of the taxpayer's relationship with his personal service corporation.

The government, citing *Furrer v. Commissioner*,[35] *Martin Ice Cream v. Commissioner*,[36] *Norwalk v. Commissioner*,[37] and *MacDonald v. Commissioner*,[38] found that the goodwill was an asset of the corporation and not of the taxpayer personally because of the contractual obligation of the taxpayer under his Employment Agreement to continue to work for and not to compete against his corporation. In granting summary judgment in favor of the government, the court found no merit in the taxpayer's argument that Washington state dissolution case law supported the proposition that professional goodwill is a community property right in dissolution cases, and as such, is of a personal nature.

[iii] Kennedy v. Commissioner. In *Kennedy v. Commissioner*,[39] the Tax Court held that payments received by a shareholder of an employee benefits consulting company which was a C corporation did not constitute payments for personal goodwill, and consequently, were taxable as ordinary income.

James Kennedy was the sole shareholder of an employee benefits consulting firm taxed as a C corporation for federal income tax purposes. Kennedy was approached by another company that proposed to acquire the assets of Mr. Kennedy's corporation. Early in the negotiations, the parties basically agreed that the purchase price should be 150% of the projected annual income to be generated from Mr. Kennedy's corporation with certain adjustments (approximately $660,000). Late in the negotiations, Mr. Kennedy's attorney consulted with a tax advisor who informed him that if the transaction was structured as an asset purchase, then the payment would be taxed twice, once at the corporate level and again at the shareholder level when distributed to Mr. Kennedy. On the other hand, if the transaction were instead structured as a purchase of the corporation's stock, there would be only one level of tax on which Mr. Kennedy would pay capital gain rates, but this would be disadvantageous to the purchaser because the purchaser would not be able to claim any deductions with respect to the purchase of the stock, and as such, would likely not agree to such an arrangement.

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35 566 F.2d 1115 (9th Cir. 1977).
36 110 TC 189 (1998).
37 TC Memo. 1998-279.
38 3 TC 720 (1944).
39 TC Memo. 2010-206.

The tax advisor alternatively suggested that Mr. Kennedy take the position that he owned the personal goodwill of the business, and that he enter into an Agreement for Assignment of Know-How and Goodwill, an Asset Purchase Agreement and a Consulting Services Agreement. Only $10,000 of the purchase price was allocated to the assets of the C corporation, with the remaining amounts being allocated 75% to the sale of Mr. Kennedy's personal goodwill and the remaining 25% being allocated to the Consulting Services Agreement.

The taxpayer argued that under *Martin Ice Cream Company v. Commissioner*,[40] the court was compelled to conclude that Mr. Kennedy owned personal goodwill and that the payments he received from the purchaser were to purchase personal goodwill since Mr. Kennedy did *not* have a non-compete agreement with his corporation.

The Tax Court, despite the fact that Mr. Kennedy had no employment agreement or non-compete agreement with his corporation, held that the amounts paid were consideration for services rather than goodwill because there was no economic reality to the contractual allocation of payments to personal goodwill. Specifically, the court found that the allocation of 75% of the total consideration paid by the purchaser to personal goodwill was a "tax-motivated afterthought" that occurred late in the negotiations.

[b] Avoidance of Double Tax by Having Ownership of Appreciated Assets in a Separate Pass-Through Entity. Tax practitioners have traditionally solved the double taxation problem by having the individual shareholders of a corporation form a partnership (general, limited or some other type of limited liability entity such as an LLP or LLC) to hold the real property or other appreciated property which would otherwise be held by the corporation. In turn, the partnership leases such property to the corporation. Although a partnership is generally superior to either a C corporation or an S corporation in terms of the ability to withdraw property from the entity without being subject to *any* tax (see Section 731(a)(1) and 731(b)), in practical terms, the partners generally will not desire to withdraw property from the partnership simply to hold such property but rather will be interested in having the partnership sell its property to a third party. In this event, both the S corporation and the partnership will produce a single level of tax, whereas the C corporation will produce a double tax.

The creation of a partnership to hold real property or other appreciated property connected with the operation of a corporation also introduces a host of administrative complexities, potential increased tax costs, and in the case of professional medical corporations, health law issues, which are not present if the corporation was an S corporation and the appreciated property was held directly by the S corporation. These additional considerations include:

[i] The preparation of partnership agreements, lease agreements, partnership tax returns and attendant Schedule K-1s.

[ii] The compliance with the federal anti-kickback rules on leases of real property to professional medical corporations.

[iii] The preparation of purchase and sale documents not only with respect to the shareholder-employee's interest in the corporation, but also with respect to the

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40 110 TC 189 (1998).

shareholder-employee's interest in the partnership holding the real property or other appreciated property.

[iv] The potential of additional taxes such as sales taxes which may be imposed on the lease payments made by the professional corporation to the partnership.

[v] If the partnership is expected to produce losses, the deductibility of such losses may be limited under the applicable basis rules, the passive activity loss rules prescribed under Section 469 or the at-risk limitation rules prescribed under Section 465.

[vi] The lease payments between the corporation and the partnership will be subject to scrutiny and may be recharacterized by the IRS if not set at a fair rental value.

Because of the additional complexities presented by having the real property or other appreciated property used in the operation of a corporation held by a partnership (LLC) rather than by the corporation itself, it may be advantageous for the corporation to operate in S corporation form so that it can directly hold such property and avoid such unnecessary complexities and potential additional taxes. One major advantage (which may very well outweigh all of the disadvantages discussed above) of having a related entity hold real property or other appreciated property rather than the corporation itself is to decrease the potential liability exposure with respect to claims against the corporation. Since all assets of a corporation are subject to claims against such corporation, the corporation would benefit if the real property and other appreciated property were held in a separate entity not subject to claims against the corporation.

[3] No Alternative Minimum Tax.

[a] General. The corporate alternative minimum tax ("AMT") is a separate and independent tax that is parallel to the "regular" corporate income tax.[41] It is designed to reduce a corporation's ability to avoid taxes by using certain deductions and other tax benefit items. The corporate AMT does this by applying to a more comprehensive base than the regular income tax, and by limiting the extent to which net operating loss carryovers and tax credits can be used to reduce taxes.

[b] Tax Base. The tax is imposed, at a rate of 20%, on alternative minimum taxable income ("AMTI"), but only to the extent AMTI exceeds an exemption amount of $40,000 reduced by 25% of the amount by which AMTI exceeds $150,000.[42] In general, AMTI is taxable income, subject to a number of special adjustments. Some items, such as depreciation, pollution control facilities, depletion and intangible drilling costs, may be treated differently for AMT than for regular tax. In addition, most corporate taxpayers must include an adjusted current earnings (ACE) adjustment to AMTI. This adjustment increases AMTI for items excluded from regular tax. One of the preference items which increases a corporation's AMTI is the adjustment made for the corporation's "adjusted current earnings" under Section 56(g). The AMTI of a corporation for any taxable year is increased by 75% of the excess (if any) of the adjusted current earnings of the corporation over such corporation's AMTI (determined without regard to its adjusted current earnings). This adjustment increases AMTI for items excluded from regular tax such as tax-exempt interest, certain dividends received deductions, the

[41] Section 55(a).
[42] Section 55(b)(1)(B), (d)(2), (d)(3)(A).

difference between LIFO and FIFO inventory and a portion of the deferred gain on installment sales.[43]

[c] Corporate-owned Life Insurance. Other common items likely to affect a corporation's adjusted current earnings are the proceeds of corporate-owned life and disability buy-out insurance, which increase the corporation's adjusted current earnings.[44] Additionally, the excess of any income on life insurance contracts held by a corporation over any portion of the premiums paid by the corporation attributable to insurance coverage will increase the adjusted current earnings of the corporation.[45] Consequently, a C corporation which has no regular income tax liability will generally be subject to an alternative minimum tax equal to 15% (20% AMTI rate x 75% adjusted current earnings percentage) of the life insurance or disability insurance proceeds received by the corporation plus 15% of the amount of inside build-up in corporate-owned life insurance policies. Although the corporate alternative minimum tax attributable to life insurance can be avoided by utilizing a cross-purchase arrangement rather than a redemption arrangement, if the corporation has more than a few shareholders it may be impracticable to utilize such a cross-purchase arrangement, thus exposing the corporation to potential alternative minimum tax.

[d] Credit. The corporate AMT generates a minimum tax credit for any AMT paid. This credit is used against regular tax (but limited by AMT) where the taxpayer is paying regular tax. Thus, AMT is essentially a prepayment of regular tax. However, it may be years before the prepayment of AMT represented by the minimum tax credit is recoverable.

[e] Exemptions. Certain "small" corporations are exempt from the AMT. These are corporations whose average annual gross receipts for all three-year periods beginning after 1993 and ending before the current year do not exceed $7.5 million.[46] For the corporation's first three-year period (or portion of a period), the limit is $5 million instead of $7.5 million.[47] This problem may be completely avoided, however, if the corporation operates in S corporation form rather than in C corporation form, since an S corporation is not subject to the alternative minimum tax.

[f] Avoidance by Use of S Corporation. This problem may be completely avoided, however, if the corporation operates in S corporation form rather than in C corporation form, since an S corporation is not subject to the alternative minimum tax.

[4] Deductibility of Interest Paid on Debt to Purchase Stock.

Under Notice 89-35,[48] debt proceeds allocated under Temp. Reg. § 1.163-8T to the purchase of stock in an S corporation, together with the associated interest expense, is allocated among the assets of the S corporation using any reasonable method. Examples of reasonable allocation methods include pro rata allocations based on the fair market value, book value or adjusted bases of the S corporation's assets, reduced by any debt of the S corporation or of the shareholders allocated to such assets. Thus, to the extent that the assets of a corporation (which

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43 *See* Sections 56 through 58.
44 Reg. § 1.56(g)-1(c)(5)(i) and (v).
45 Reg. § 1.56(g)-1(c)(5)(ii).
46 Section 55(e)(1)(A).
47 Section 55(e)(1)(B).
48 1989-1 C.B. 675.

is an S corporation) are assets used in the conduct of the corporation's trade or business, the interest expense on debt incurred to purchase the stock of the S corporation will be fully deductible as trade or business interest and not subject to the investment interest limitations prescribed under Section 163(d). To the extent that the assets of an S corporation constitute investment assets, however, an allocable portion of the interest expense associated with the debt incurred to purchase the S corporation stock will be subject to the §163(d) investment interest limitation.

In the case of the purchase of stock in a corporation which is a C corporation, there is a reasonable possibility that the interest expense associated with the debt incurred to purchase such stock will be subject to the investment interest limitations prescribed under Section 163(d). Specifically, the C corporation shareholder must show that he or she had no "substantial investment motive" in purchasing the stock of the corporation in order to avoid the investment interest limitation rules.[49] In other words, the C corporation shareholder must show that his or her purchase of the stock of the corporation was made to protect the shareholder-employee's status as an *employee* of the corporation rather than as a *shareholder* of the corporation. Although there is a greater likelihood in the C context than in the S context that the interest expense associated with debt incurred by a shareholder to purchase stock will be characterized as investment interest, in the professional service corporation setting, the C corporation shareholder would have a better chance of demonstrating the lack of a substantial investment motive in purchasing such stock, especially where such shareholder's stock is subject to a shareholders' agreement which subjects his or her shares to repurchase upon termination of employment at a purchase price based upon the *book value* of such shares, which is common in many professional service corporations.

[5] Limitation of Social Security Taxes.

As part of FICA, a tax is imposed on employees and employers up to a prescribed maximum amount of employee wages. This tax is comprised of two parts, the Old-Age, Survivor, and Disability Insurance (OASDI) portion and the Medicare Hospital Insurance (HI) portion. The HI tax rate is 1.45% on both the employer and the employee, and the OASDI tax rate is 6.2% on both the employer and the employee. The maximum wages subject to the OASDI tax rate for 2017 is $127,200.00.

Under SECA, a tax is imposed on an individual's self-employment income. The self-employment tax is the same as the total rate for the employer's and employee's FICA tax (2.9% HI tax rate and 12.4% OASDI tax rate).

RRA '93 repealed the dollar limit on wages and self-employment income subject to the HI portion of the FICA tax as well as the self-employment tax. Thus, employers and employees will equally be subject to the 1.45% HI tax on *all* wages, and self-employed individuals will be subject to the 2.9% HI tax on *all* self-employment income.

The Health Care and Education Reconciliation Act of 2010 increased the Medicare portion of the self-employment tax by .9% (to 3.8%) on wages in excess of $250,000 in the case of taxpayers filing a joint return and more than $200,000 for other taxpayers.

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[49] See *Polakis v. Commissioner*, 91 TC 660 (1988); *Miller v. Commissioner*, 70 TC 448 (1978); *Houston v. Commissioner*, TC Memo. 1989-175; *Olson v. Commissioner*, TC Memo. 1989-564.

Because the Federal Insurance Contributions Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes may be substantial, many shareholder-employees of S corporations have employed a strategy of decreasing the amount of wages that they receive from the S corporation and correspondingly increasing the amount of S corporation distributions made to them.

In order for shareholder-employees of S corporations to realize employment tax savings by withdrawing funds in the form of distributions rather than compensation, such distributions must not be recharacterized as "wages" for FICA purposes or as NESE for purposes of the SE Tax. For FICA and FUTA purposes, Section 3121(a) and 3306(b), respectively, define the term "wages" to mean all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Although it might appear at first glance that a shareholder's distributive share of income from an S corporation constitutes NESE since a general partner's distributive share of the income of any trade or business carried on by a partnership of which he is a member generally constitutes NESE subject to the SE Tax, in Rev. Rul. 59-221,[50] the IRS found that an S corporation's income does not constitute NESE for purposes of the SE Tax. Additionally, Section 1402(a)(2) specifically excludes from the definition of NESE dividends on shares of stock issued by a corporation.

Consequently, neither a shareholder's distributive share of income passed through from the S corporation under Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute NESE subject to the SE Tax. In Rev. Rul. 66-327,[51] the IRS found that the taxable income of an S corporation included in its shareholders' gross income is not income derived from a trade or business for purposes of computing the shareholders' net operating losses under Section 172(c). Similarly in Ltr. Rul. 8716060, the IRS concluded that the income derived by a shareholder-employee from an S corporation did not constitute net earnings from self-employment for self-employment tax purposes and that such taxpayer was not eligible to adopt a qualified pension plan based on the income derived from his S corporation since such income did not constitute earned income.

Because wages paid to shareholder-employees of S corporations are subject to Social Security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages. Prior to advising an S corporation with shareholder-employees to undertake such a tax planning strategy, however, the tax practitioner should analyze the economic and tax consequences that such a strategy will have on the S corporation and its shareholders.

Although the amount of funds available for distribution to an S corporation's shareholder-employees will increase as the wages paid to them decrease, all distributions made by the S corporation to its shareholders must be made in proportion to the number of shares held by such shareholders under Section 1361(b)(1)(D). Thus, if an S corporation which has both shareholders who are employees and shareholders who are not employees adopts a tax strategy to

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[50] 1959-1 C.B. 225.

[51] 1966-2 C.B. 357.

reduce Social Security taxes by minimizing wages and maximizing distributions, the increase in the amount of distributions received by the shareholders who are employees will be less than the amount by which their wages were reduced (since distributions must also be made to the shareholders who are not employees). Additionally, a program that minimizes the amount of wages paid to shareholder-employees will increase: (1) purchase price formulas based on earnings; and (2) bonus formulas based on earnings. Decreasing the amount of wages paid to shareholder-employees of S corporations also will reduce the contribution base for contributions to the corporation's qualified plans.

[a] Rev. Rul. 74-44. In addition to these economic considerations, the tax practitioner should also analyze the tax consequences of making distributions to the corporation's shareholders. In Rev. Rul. 74-44,[52] two shareholders of an S corporation withdrew *no salary* from the corporation and arranged for the corporation to pay them dividends equal to the amount that they would have otherwise received as reasonable compensation for services performed. This arrangement was made for the express purpose of avoiding payment of federal employment taxes. Based on the expansive definition of wages for FICA and Federal Unemployment Tax Act ("FUTA") purposes (which includes all remuneration for employment), the IRS found that the dividends paid to the shareholders constituted wages for FICA and FUTA purposes. Rev. Rul. 74-44 did not, however, address the issue of what constitutes reasonable compensation in the S corporation context since the ruling expressly stated that the dividends were received by the shareholder-employees in lieu of the reasonable compensation that would have otherwise been paid to them. Despite this shortcoming, Rev. Rul. 74-44 clearly indicates that the payment of *no* compensation will be unreasonable where shareholder-employees provide substantial services to the corporation.[53]

[b] *Radtke, Spicer Accounting*. In *Radtke v. United States,*[54] the court recharacterized distributions made to the sole shareholder (an attorney) of an S corporation (a law firm) as wages subject to FICA and FUTA taxes, where the shareholder made all of his withdrawals from the S corporation in the form of S corporation distributions and received *no salary* from the S corporation during the tax year. The court relied on a broad definition of wages for FICA and FUTA purposes as all remuneration for employment, and concluded that the dividend payments were remuneration for services performed by the shareholder for the S corporation. Likewise, in *Spicer Accounting, Incorporated v. United States,*[55] the court recharacterized dividend distributions made to a shareholder (an accountant) of an S corporation (an accounting firm) as wages subject to FICA and FUTA taxes where the shareholder received *no salary* during the tax year.

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[52] 1974-1 C.B. 287.

[53] See also Rev. Rul. 71-86, 1971-1 C.B. 285 (president and sole shareholder of closely-held corporation found to be an "employee" of the corporation for employment tax purposes); Rev. Rul. 73-361, 1973-2 C.B. 331 (officer-shareholder of an S corporation who performed substantial services as an officer of the S corporation is an "employee" of the corporation for purposes of FICA, FUTA and income tax withholding); and Ltr. Rul. 7949022 (shareholder-employees of S corporation who perform substantial services for S corporation treated as "employees" for employment tax purposes).

[54] 895 F.2d 1196 (7th Cir. 1990).

[55] 918 F.2d 80 (9th Cir. 1990).

[c] Esser. Additionally, in *Fred R. Esser, P.C. v. United States,*[56] the court recharacterized amounts received by the sole shareholder, officer and director of a legal services S corporation, as wages subject to FICA and FUTA taxes, rather than as distributions. As in the *Radtke* and *Spicer Accounting* cases, the shareholder received *no salary* from the S corporation during the tax year.

[d] Cave. In *Donald G. Cave, A Professional Law Corp. v. Commissioner*,[57] the court recently held that all of the non-shareholder attorneys, as well as a law clerk, of a law firm were common law employees rather than independent contractors, and also recharacterized the distributions made to the sole shareholder of the law firm, who was determined to be a statutory employee, as wages subject to Social Security taxes.

[e] Watson. In *David E. Watson P.C. v. United States*,[58] the Eighth Circuit Court of Appeals affirmed the decision of the district court recharacterizing a significant portion of dividend distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes.

During the years in issue, 2002 and 2003, David E. Watson, CPA ("Watson"), provided accounting services to a partnership ("LWBJ") and its clients as an employee of David E. Watson P.C., an S corporation (the "S Corporation"). The S Corporation was a 25% partner in LWBJ. The IRS made assessments against Watson after it determined that portions of the dividend distributions from the S Corporation to Watson should be recharacterized as wages subject to employment taxes. Specifically, the IRS contended that $130,730.05 out of a total of $203,651 of dividend payments to Watson for 2002 should be recharacterized as wages subject to employment taxes, and that $175,470 out of a total of $203,651 of dividend payments to Watson for 2003 should be recharacterized as wages subject to employment taxes. In both years, Watson received a salary of $24,000 in addition to the dividend distributions.

In his Motion for Summary Judgment, Watson argued that the intent of the S Corporation was controlling in determining the characterization of the payments from the S Corporation to Watson. Because the S Corporation clearly intended to pay Watson compensation of only $24,000 per year, Watson contended that any amounts distributed in excess of the $24,000 were properly classified as dividends. In support of his position, Watson cited *Electric & Neon, Inc. v. Commissioner*,[59] *Paula Construction Co. v. Commissioner*,[60] and *Pediatric Surgical Associates, P.C. v. Commissioner*.[61]

Citing Rev. Rul. 74-44,[62] *Radtke, Spicer Accounting* and *Veterinary Surgical Consultants*, the district court found that the intent of the S Corporation was not controlling in determining the character of the payments, but rather that the analysis turns on whether the payments at issue were made as remuneration for services performed. Consequently, the court denied Watson's Motion for Summary Judgment because it found that there was a genuine issue

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56 750 F. Supp. 421 (D. Ariz. 1990).
57 109 AFTR 2d 2012-609 (5th Cir. 2012), *aff'g per curiam*, TC Memo. 2011-48.
58 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).
59 56 TC 1324 (1971).
60 58 TC 1055 (1972).
61 TC Memo. 2001-81.
62 1974-1 CB 287.

of material fact as to whether the dividends paid to Watson by the S Corporation were remuneration for services performed subject to employment taxes.

After denying the taxpayer's Motion for Summary Judgment, the district court held a bench trial on the merits. At trial, the government's expert opined that the market value of Watson's accounting services was approximately $91,044 per year for 2002 and 2003. The government's expert was a general engineer with the IRS and had worked on approximately 20 to 30 cases involving reasonable compensation issues. In forming his opinion as to Watson's salary, the government's expert relied on several compensation surveys and studies particularly relating to accountants. The district court ultimately adopted the government expert witness's opinion and determined that the reasonable amount of Watson's remuneration for services performed totaled $91,044 for each of 2002 and 2003.

In addition to determining the issues of what constituted reasonable compensation to the sole shareholder of the S corporation and whether intent was the determinative factor in determining whether payments from an S corporation to its sole shareholder should be characterized as wages or as dividend distributions, the court first addressed the taxpayer's argument that the district court erred in allowing the government's expert to testify on the issue of reasonable compensation because he was not competent to testify on that issue. Specifically, the taxpayer asserted that the government's expert witness was not qualified, changed his opinion, relied on insufficient underlying facts, and used flawed methods in rendering his opinion. After reviewing all of these factors in detail, the court of appeals determined that the district court did not abuse its discretion in admitting the testimony of the government's expert witness, and found the taxpayer's arguments meritless.

In reaching its decision, the Eighth Circuit Court of Appeals cited Rev. Rul. 74-44, *Radtke, Spicer Accounting* and *Veterinary Surgical Consultants* cases (discussed above), and concluded that the district court properly determined that the characterization of funds disbursed by an S corporation to its shareholders turns on an analysis of whether the payments at issue were made as remuneration for services performed. The court went on to state that the district court found that the S corporation understated wage payments to its sole shareholder by $67,044 in each year based on a variety of factors. These factors included the following evidence: (1) Watson was an exceedingly qualified accountant with an advanced degree and nearly 20 years in accounting and taxation; (2) Watson worked 35-45 hours per week as one of the primary earners in a reputable firm, which had earnings much greater than comparable firms; (3) the partnership had gross earnings of over $2M in 2002 and nearly $3M in 2003; (4) $24,000 is unreasonably low compared to other similarly situated accountants; (5) given the financial position of the partnership, Watson's experience and his contributions to the partnership, a $24,000 salary was exceedingly low when compared to the roughly $200,000 the partnership distributed to Watson's S corporation in 2002 and 2003; and (6) the fair market value of Watson's services was $91,034.

The Eighth Circuit Court of Appeals next addressed the taxpayer's argument that instead of focusing on reasonableness, the district court should have focused on the S corporation's intent. While acknowledging that Section 162(a)(1) provides that the deductibility of compensation is a two prong test in that the compensation must both be reasonable in amount and in fact payments purely for services, the court, citing *Elliotts, Inc. v. Commissioner*,[63] stated

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[63] 716 F.2d 1241, 83-2 USTC ¶9610 (9th Cir. 1983), *rev'g* TC Memo. 1980-282.

that courts usually only need to examine the first prong since the reasonableness prong generally subsumes the inquiry into compensatory intent in most cases. The court did state however, that in certain rare cases whether there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness.

In the case, the taxpayer cited *Pediatric Surgical Associates* in support of his position that taxpayer intent controls in FICA tax characterization cases. The Eighth Circuit Court of Appeals found that even if intent does control, after evaluating all the evidence, the district court specifically found that the shareholder's assertion that the S corporation intended to pay him a salary of only $24,000 a year to be less than credible. Additionally, the Eighth Circuit Court of Appeals went on to reject the argument made by the taxpayer that *Pediatric Surgical Associates* limited the amount that could be characterized as wages to the amount of revenue each shareholder-employee personally generated less expenses since, like *Pediatric Surgical Associates*, nonshareholder-employees also contributed to the S corporation's earnings. The Eighth Circuit Court of Appeals brushed this argument aside by saying that although they thought evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in light of all the evidence presented to the district court in the case, they saw no error and affirmed the decision of the district court.

[f] Herbert. In *Herbert v. Commissioner*,[64] the Tax Court recharacterized a portion of the amounts the taxpayer claimed were used to pay business expenses as wages subject to Social Security taxes, finding the taxpayer's salary was unreasonably low. However, the Tax Court expressly rejected the Service's contention that the taxpayer's salary be increased by $52,600, primarily based on the salary paid by the S corporation to the shareholder in a prior year in which the business was not owned by the taxpayer.

In reaching this decision, the Tax Court believed and accepted the taxpayer's testimony that the taxpayer in fact paid significant expenses of the corporation with cash funds received from the corporation. Additionally, the court found that in spite of limited evidence before them, they believed that it was improper and excessive to charge the taxpayer with receipt from the corporation in 2007 of $52,600 in additional wages. On the other hand, the court stated that the taxpayer's reported wages of $2,400 was unreasonably low.

Consequently, citing *Mayson Manufacturing Co. v. Commissioner*,[65] the Tax Court averaged the taxpayer's wages for 2002 through 2006, and used the average amount as the total for the taxpayer's 2007 wages subject to employment taxes ($30,445).

[g] McClary. In *Sean McClary Ltd., Inc. v. Commissioner*,[66] the Tax Court recharacterized the distributions made by an S corporation to its sole shareholder as wages subject to Social Security taxes where the shareholder received no salary from the S corporation and also found that the annual compensation formula contained in the Board of Directors minutes setting a salary of $24,000 was unreasonably low.

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64 TC Summ Op 2012-124.
65 178 F2d 115 (6th Cir 1949).
66 TC Summ Op 2013-62.

Mr. McClary was the president, secretary, treasurer, sole director and sole shareholder of his S corporation. He managed all aspects of the S corporation's operations, including recruiting and supervising sales agents, conducting real estate sales, procuring advertising, purchasing supplies, and maintaining basic books and records, Mr. McClary often worked 12-hour days with few days off. For the year in issue, Mr. McClary supervised eight sales agents, four of whom generated sales commissions for the S corporation that year, but most of the S corporation's gross receipts were attributable to sales commissions generated by Mr. McClary himself.

For the year in issue, the S corporation did not issue a Form W-2, Wage and Tax Statement, to Mr. McClary, nor did it claim a deduction for the amount paid to Mr. McClary as wages or compensation for services. During such year, Mr. McClary transferred a total of $240,000 from the S corporation's account to his personal account.

In determining what portion of the $240,000 of distributions should be recharacterized as wages, the IRS's expert witness found that $100,755 represented reasonable compensation for services rendered by Mr. McClary for the year in issue. On the other hand, Mr. McClary argued that even though he did not pay himself a salary, the salary of $24,000 set forth in the compensation arrangement in the corporation's minutes should be the only amount characterized as wages subject to Social Security taxes.

The Tax Court, citing the multi-factor test used in determining reasonable compensation for shareholder employees of C corporations, found that reasonable compensation for Mr. McClary's services during the year in issue was $83,200, and as such, recharacterized $83,200 of the $240,000 distributed by the S corporation to Mr. McClary as wages subject to Social Security taxes.

[h] <u>*Glass Blocks*</u>. In *Glass Blocks Unlimited v. Commissioner*,[67] the Tax Court recharacterized the total distributions made by an S corporation to its president, sole shareholder and only full-time employee, of $30,844 in 2007 and $31,644 in 2008, as wages subject to Social Security taxes.

Citing *Veterinary Surgical Consultants P.C. v. Commissioner*,[68] Yeagle Drywall Co v Commissioner,[69] that an officer who performs more than minor services for a corporation and receives remuneration in any form for those services is considered an employee, and his or her wages are subject to the employer's payment of federal employment taxes, the court went on to find that the taxpayer was the S corporation's only officer, and sole full-time worker in 2007 and 2008 and performed substantially all the work necessary to operate the business.

The Tax Court went on to reject the taxpayer's argument that the distributions constituted repayment of shareholder loans, and the taxpayer's argument that the characterization of all distributions from the S corporation to him as wages constituted unreasonably high compensation to him, citing the multi-factor test used in *Elliotts, Inc. v. Commissioner*.[70] Consequently, the Tax Court found that the total amount of distributions made by the S

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67 TC Memo 2013-180.
68 117 TC 141 (2001), *aff'd sub nom.*

69 54 Fed Appx 100 (3d Cir 2002).
70 716 F2d 1241 (9th Cir 1983), *rev'g* TC Memo 1980-282.

corporation to its sole shareholder constituted wages subject to Social Security taxes for the years in issue.

[i] Observation. The *Watson* case, the *Herbert* case and the *McClary* case are the first reported decisions in which the court was presented with a situation which was not clearly abusive such as those presented in *Radtke* and *Spicer Accounting* (i.e, where ***all*** of the earnings of the S corporations were paid to the sole shareholder as dividend distributions and no salary was paid to the shareholder by the S corporation). The *Watson, Herbert,* and *McClary* cases likewise involve situations where only a portion of amounts not treated as wages are recharacterized as wages subject to Social Security taxes, ***and each involves different methods in determining what constitutes "reasonable compensation" to the shareholder-employees of an S corporation***. Consequently, the *Watson, Herbert* and McClary decisions represent important victories for the IRS in being able to recharacterize dividend distributions as wages where at least some (but less than a reasonable) salary has been paid to the shareholder-employees of the S corporation. On the other hand, these cases can be viewed as favorable to taxpayers as they allowed personal service S corporations to distribute significant amounts of their income ***without*** being subject to Social Security taxes. However, the *Watson* case is somewhat troubling in its rejection of the decision reached in the *Pediatric Surgical Associates, P.C.* case (in which the IRS sought to recharacterize wages of a C corporation as dividend distributions rather than vice versa), in that the court did not seem to take into account the fact that dividend distributions can indeed be generated by the services of nonshareholder-employees of an S corporation or from other ancillary services not provided by the shareholder-employees of the S corporation.

[j] Abusive versus Non-Abusive Situations. The *Radtke, Spicer Accounting* and *Esser* cases indicate that in ***abusive situations***, such as ***where the shareholders*** of an S corporation make all withdrawals from the S corporation in the form of S corporation distributions and ***receive no salary from the S corporation*** during the tax year, the courts can and will recharacterize such distributions as wages subject to Social Security taxes. These earlier cases have been followed in more recent cases.[71]

In non-abusive situations, however, the IRS may have difficulty in successfully asserting that distributions made by S corporations to shareholder-employees should be recharacterized as wages subject to Social Security taxes. In order for the IRS to recharacterize S corporation distributions as wages subject to Social Security taxes in non-abusive situations, the IRS would have to overcome: (i) the lack of express authority for its position (unlike the express authority granted to the IRS under Section 1366(e) to recharacterize dividend distributions as wages in the family context); (ii) the burden of overcoming the initial characterization of the payment as a distribution; and (iii) the uncertainty surrounding the utilization of Section 162(a)(1) by the IRS in the employment context to bring salaries ***up*** to a reasonable level.

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[71] *See Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 14 (2001); *Van Camp & Brennion v. United States*, 251 F.3d 862 (9th Cir. 2001); *Olde Raleigh Realty Corp. v. Commissioner*, T.C. Summ. Op. 2002-61; *David E. Watson P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012), *aff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010); *Herbert v. Commissioner*, T.C. Summ. Op. 2012-124; *Sean McClary Ltd., Inc. v. Commissioner*, T.C. Summ. Op. 2013-62; *Glass Blocks Unltd. v. Commissioner*, T.C. Memo 2013-180.

The key is obviously determining what is an abusive situation versus a non-abusive situation regarding reasonable compensation in the S corporation context. In IRS Fact Sheet 2008-25, August, 2012, the IRS provides that although there is no "bright line" test for determining what constitutes "reasonable compensation" to S corporation shareholder-employees, a multi-factor type analysis similar to the factors set forth in *Mayson Manufacturing Co.* should be used.[72] In *Herbert*, the court expressly stated that it was applying a multi-factor test to determine reasonable compensation, but actually used an average salary approach in determining the reasonable compensation of the shareholder-employee. The court in the *Watson* case relied on expert witness testimony as to the reasonableness of compensation, and in the *McClary* and *Glass Blocks* cases, the court cited that the multi-factor test was being used to determine the reasonableness of compensation without going into an in-depth analysis of those factors in such cases. In any event, it would seem absolutely inappropriate to apply the independent investor test to determine the reasonableness of compensation in the S corporation context, as that would result in all of the amounts being received by the shareholder-employees of an S corporation being characterized as wages other than the amounts determined to be a reasonable rate of return payable to the hypothetical independent investor.

[k] <u>IRS Fact Sheet FS-2008-25</u>. In IRS Fact Sheet FS-2008-25, the IRS clarified information that small business taxpayers should understand regarding the tax law for corporate officers who perform services for S corporations.[73] In the Fact Sheet, the IRS points out that just because an officer is also a shareholder of the S corporation, it does not change the requirement that payments to the corporate officer must be treated as wages, and that courts have consistently held that S corporation officer-shareholders who provide more than minor services to the corporation and who receive or are entitled to receive payments are employees whose compensation is subject to federal employment taxes.

The Fact Sheet goes on to discuss that although there are no "bright line" tests for determining what constitutes "reasonable compensation" to S corporation officer-shareholders, the following factors have been considered by the courts in determining reasonable compensation:

- Training and experience.
- Duties and responsibilities.
- Time and effort devoted to the business.
- Dividend history.
- Payments to non-shareholder employees.
- Timing and manner of paying bonuses to key people.
- What comparable business pay for similar services.
- Compensation agreements.

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[72] IRS, FS-2008-25, "Wage Compensation for S Corporation Officers" (August 2008), http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers (last updated Aug. 18, 2012).
[73] *Id*.

- The use of a formula to determine compensation.

Consequently, in non-abusive situations, a tax strategy of decreasing wages and correspondingly increasing distributions to shareholder-employees could result in substantial employment tax savings**.** As a result of this tax planning technique, the IRS, the Joint Committee on Taxation, the Department of Treasury, Congress and the press have issued reports and notices, introduced legislation and issued comments addressing the use of S corporations as a means of avoiding the self-employment tax.

[l] *PMTA 2017-005*. In *PMTA 2017-005* (March 30, 2017), the IRS determined that the Tax Court does not have jurisdiction under Section 7436 to review a determination that a corporation is liable for additional employment taxes due to the IRS's recharacterization of payments made to, or on behalf of, corporate officers who were treated as employees.

Section 7436(a) provides the Tax Court with limited jurisdiction to review certain employment tax determinations made by the IRS and the proper amount of employment tax under such determinations. Specifically, the Tax Court has jurisdiction to review determinations that: (1) individuals are employees for purposes of employment taxes under Subtitle C of the Code (i.e., requiring reclassification of a non-employee to employee status); or (ii) the person for whom services are performed is not entitled to relief under Section 530.

In *PMTA 2017-005*, the IRS reasoned that the dispute in issue was limited to the correct amount of payments required to be treated as "wages" for employment tax purposes, as opposed to a dispute as to whether the corporate officers were employees of the taxpayer under Section 3121(d)(1). Additionally, the IRS found that there was no dispute concerning entitlement to Section 530 relief.

Consequently, the IRS concluded that because it was not making a determination regarding the employment status of the corporate officers when it recharacterizes certain payments as wages that were not treated as wages, and is also not making a determination with respect to entitlement to Section 530 relief, the Tax Court lacks jurisdiction to determine the correct amount of employment taxes due as a result of the employment tax assessment under Section 6201 on the additional wages.

If *PMTA 2017-005* is followed by the Tax Court, where the IRS recharacterizes a portion of the distributions made by an S corporation to its shareholder employees as wages subject to social security taxes, it would seem the taxpayers would have no choice but to pay the tax and file in district court for a tax refund. This seems contrary to a number of decisions previously issued by the Tax Court on the reclassification of distributions as wages where the Tax Court never questioned its jurisdiction in such matters.

[6] Avoidance of 3.8% Tax on Net Investment Income for Material Participation Owners.

The ACA imposes a 3.8% tax on the "net investment income" of taxpayers having modified adjusted gross income of over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers (the "NII Tax"). "Net investment income" includes gross

income from interest, dividends, annuities, royalties, and rents other than such income which is derived in the ordinary course of a trade or business.[74]

Additionally, the term "net investment income" includes: (1) any other gross income derived from a trade or business if such trade or business is a "passive activity" within the meaning of Section 469, with respect to the taxpayer; and (2) any net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity under Section 469 with respect to the taxpayer.[75]

Consequently, now a partner, including a limited partner, LLC member and an S corporation shareholder, will be subject to the new 3.8% net investment income tax on his or her distributive share of the *operating income* of the partnership, LLC or S corporation, as the case may be, if the activity generating such income is passive under Section 469 with respect to such partner, LLC member or S corporation shareholder.

As discussed above, shareholder-employees of S corporations are generally not subject to Social Security taxes on their distributive share of the income of an S corporation or on dividend distributions made to them by their S corporation, provided the S corporation pays reasonable compensation to them.[76] Thus, there is an opportunity for significant employment tax savings by maximizing the amount of distributions and minimizing the amount of wages paid to shareholder-employees of S corporations.

Additionally, so long as a shareholder of an S corporation materially participates in the business of his or her S corporation, the dividend distributions received by such shareholder should not be subject to the 3.8% NII Tax. Thus, non-wage distributions from S corporations are one of the few paths to receive income untouched by the FICA tax, self-employment tax or the new NII Tax. Some commentators have suggested that this may be "abusive" in the case of personal service S corporations.[77]

First of all it's important to recognize that non-wage distributions from a non-personal service corporation, such as a manufacturing company, are also not subject to these taxes provided the shareholder materially participates in the business. It is also important to recognize that with respect to personal service S corporations, the IRS and the courts can and have recharacterized nonwage distributions as "wages" subject to the FICA tax where unreasonably low compensation is being paid to the S corporation shareholders, so that personal service S corporations may not "avoid" the FICA tax on amounts distributed as dividends if they are in substance wages (see *Radtke v. United States*,[78] *Spicer Accounting, Incorporated v. United States*[79] and recently the *David E. Watson P.C. v. United States*[80] and *Herbert v. Commissioner*[81]

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74 Section 1411(c)(1)(A)(i).

75 1411(c)(1)(A)(ii) and (iii).

76 See Rev. Rul. 59-221, 1951-1 CB 225 and Section 1402(a)(2).

77 See Trivedi, et al, "Practitioners Busy with Net Investment Income Tax Regs," Tax Notes, Dec 10, 2012, p 1149, Doc 2012-25152, 2012 TNT 234-1.

78 895 F.2d 1196 (7th Cir 1990).

79 918 F2d 80 (9th Cir 1990).

80 668 F.3d 1008 (8th Cir 2012), *aff'g* 757 F Supp 2d 877 (SD Iowa 2010).

81 TC Summ Op 2012-124.

cases). It is also important to note that both the IRS and the courts expressly recognize that a so-called personal service corporation may indeed produce earnings that are properly characterized as dividend distributions rather than wages (see the recent *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*[82] case, as well as the *Pediatric Surgical Associates, P.C. v. Commissioner*[83] and the *Richlands Medical Association v. Commissioner*[84] cases). Quite simply, the FICA and SE taxes were meant to only apply to wages of an individual for personal services he or she actually renders, and not to active operating income (profits) of a business paid out as dividend distributions to shareholders. On the other hand, the NII tax was meant to subject certain higher income taxpayers to the 3.8% tax on passive type investment income, not to the profits of a business in which they materially participate. Consequently, any suggestion that the use of S corporations to "avoid" these three taxes is abusive simply misses the mark as entrepreneurial profits of a business not attributable to wages paid for personal services actually rendered by a shareholder were never intended to be subject to any of these three taxes.

Although it may be possible for an LLC member or limited partner to materially participate so that his or her distributive share of income would not be subject to the NII Tax, as will be discussed in more detail below, that would likely result in that member's or partner's distributive share of the income of the LLC or partnership being subject to the self-employment tax, including the increased 3.8% tax imposed on the self-employment income of higher income taxpayers.[85] Thus, S corporations appear to be the most attractive vehicle in which to operate a business to minimize both employment taxes and the NII Tax.

[7] Avoidance of the Accumulated Earnings Tax.

S corporations and other pass-through entities are not subject to the Accumulated Earnings Tax imposed under Section 531.

[a] General. The accumulated earnings tax is a penalty tax imposed upon C corporations that accumulate earnings in excess of the reasonable needs of the business, rather than pay them out to shareholders, with the purpose of avoiding taxes at the shareholders level.[86]

[b] Tax Base. The accumulated earnings tax normally applies to the accumulated taxable income at the highest tax rate imposed on single filers, but the 2003 Act has reduced that rate to 15% for tax years beginning after December 31, 2002 and before January 1, 2009. Accumulated taxable income is the corporation's taxable income, subject to certain adjustments, reduced by: (A) the dividends-paid deduction, if any, and (B) the accumulated earnings credit.[87] The adjustments, as provided in Section 535(b), include: (A) income taxes accrued to the corporation for the year; (B) corporate charitable contributions over the 10% deduction limit under Section 170(b)(2); (C) the corporation's capital losses disallowed under Section 1211; and (D) the corporation's net capital gain for the year. The accumulated earnings credit is an amount that starts at $250,000 but could be higher if justified by the reasonable

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[82] 680 F.3d 867 (7th Cir 2012).

[83] TC Memo 2001-81.

[84] TC Memo 1990-660.

[85] See *Renkemeyer, Campbell & Weaver, LLP v Commissioner*, 136 TC 137 (2011); *Howell v Commissioner*, TC Memo 2012-303; *Riether v Commissioner*, 919 F Supp 2d 1140 (DNM 2012); and CCA 201436049.

[86] Section 531.

[87] Section 531(a).

business needs of the corporation. In other words, the accumulated earnings credit is designed to allow corporations to retain at least $250,000 and as much of earnings as is supported by the reasonable needs of the business.[88] The minimum accumulated earnings credit is determined annually as the excess of $250,000 over the corporation's accumulated earnings at the end of the preceding tax year.[89] (Note that corporations performing services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting may claim a minimum accumulated earnings credit of only the excess of $150,000 over accumulated earnings at the end of the preceding tax year.) Thus, if a corporation had no prior years' accumulated earnings, the current year's minimum accumulated earnings credit would be $250,000. If the corporation's prior year accumulated earnings were $100,000, however, the minimum credit would be $150,000 ($250,000 minus $100,000).

[c] Reasonable Business Needs. As mentioned above, there are two basic elements that must be present in order for the accumulated earnings tax to apply. First, there must be an accumulation of earnings beyond the reasonable needs of the business. Second, the earnings had to have been accumulated for the purpose of avoiding shareholder level taxes. Thus, a corporation is generally able to avoid the accumulated earnings tax if it can demonstrate that it retained the earnings for its reasonable business needs. Whether particular grounds indicate that earnings have been accumulated for reasonable business needs or beyond depends on the specific circumstances.[90] Generally, an accumulation of earnings is excessive if it is more than what "a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business."[91] In addition, the retained earnings must be directly connected with the needs of the corporation and must be for bona fide business purposes. The "business" of a corporation includes not only that which it has previously carried on but also any line of business it may undertake.[92]

[d] Tax Avoidance Purpose. Even if a corporation has accumulated earnings beyond its reasonable needs, the earnings must have been retained for the purpose of avoiding taxes at the shareholders' level in order for the accumulated earnings tax to apply. Note, however, that unreasonable accumulations create a presumption of a tax-avoidance purpose, rebuttable by the corporation.[93] Tax avoidance needs only be one of the purposes, not the sole or dominating purpose, of the accumulation.[94] Although the Code does not specify the person or persons whose purpose is relevant in determining liability for the accumulated earnings tax, it is presumably the purpose of those who control the corporation, through stock ownership or otherwise, that is key. The following factors are among those considered in determining whether a corporation's retention of earnings was motivated by a tax-avoidance purpose:

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[88] Section 535(c).
[89] Section 535(c)(2).
[90] Reg. § 1.537-2(a).
[91] Reg. § 1.537-1(a).
[92] Reg. § 1.537-3(a). *See also* Reg. § 1.537-2(b) for examples of specific grounds for accumulations most frequently encountered in reasonable business needs cases.
[93] Section 533(a).
[94] *U.S. v. Donruss Co.,* 393 US 297 (1969).

[i] Dealings between the corporation and its shareholders, including loans and advances to shareholders and expenditures of corporate funds for the shareholders' personal benefit (rather than paying dividends).[95]

[ii] Investing undistributed earnings in assets having no reasonable connection to the corporation's business.[96]

[iii] A dividend history demonstrating that shareholder taxes were avoided by the corporation's failure to make distributions.[97]

[iv] Corporate loans to friends or relatives of shareholders, as well as to other corporations owned directly or indirectly by the shareholders.[98]

[e] Exceptions. The accumulated earnings tax imposed under Section 531 does not apply to a personal holding company within the meaning of Section 542, a foreign personal holding company within the meaning of Section 552, a corporation exempt from tax under Subchapter F, and a passive foreign investment company within the meaning of Section 1296.[99]

[8] Avoidance of the Personal Holding Company Tax.

S corporations and other pass-through entities are not subject to the Personal Holding Company Tax imposed under Section 541.

[a] General. A closely held corporation whose income is largely of investment character may be a personal holding company (PHC), in which case a penalty tax is imposed on the "personal holding company income" if not distributed. The personal holding company tax is designed to prevent corporations from accumulating earnings rather than distributing the earnings as taxable dividends.

[b] Definition. A corporation is a personal holding company if: (i) at least 60% of its adjusted ordinary gross income (as defined in Section 543(b)(2)) for a taxable year is personal holding company income, and (ii) at any time during the last half of the taxable year, more than 50% in value of the corporation's stock is owned, directly or indirectly, by or for not more than five individuals.[100]

[c] PHC Income. Personal holding company income generally includes dividends, interest, royalties (including mineral, oil and gas royalties and copyright royalties), annuities, rents, produced film rents, compensation for use of corporate property by shareholders, personal service contract income, and income from estates and trusts.[101] In general, undistributed personal holding company income means "taxable income" (as adjusted by the items set forth in Section 545(b)), less the dividends paid deduction (as defined in Section

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[95] *See* Internal Revenue Manual 4586, 635 (04/23/81).
[96] Id.
[97] Id.
[98] Reg. § 1.537-2(c).
[99] Section 532(b).
[100] Section 542(a).
[101] Section 543(a).

561).[102] Adjustments to taxable income generally include negative adjustments for federal income taxes, certain net operating losses, and net capital gains less the attributable taxes.

[9] Absence of Limitations on Use of Cash Method of Accounting.

S corporations are not subject to the limitations placed upon C corporations (other than qualified personal service corporations within the meaning of Section 448(d)(2) and C corporations having average annual gross receipts of $5,000,000 or less) on using the cash method of accounting.

[10] Ability to Use Pass-Through Losses to Offset Other Income.

The pass through of losses from an S corporation (or other pass-through entity) to its owners which may be deducted, subject to certain limitations, against the owners' other income.

[11] Avoidance of State Income Taxes.

Some states impose income taxes on C corporations but not on S corporations.[103]

1.05 DISADVANTAGES OF OPERATING A CORPORATION AS AN S CORPORATION (OR OTHER PASS-THROUGH ENTITY) VERSUS A C CORPORATION.

Although there are significant advantages to operating an entity as an S corporation or other pass-through entity rather than as a C corporation, there are several disadvantages which must be carefully analyzed before making the decision to utilize an S corporation or other pass-through entity rather than a C corporation to operate a business or to convert an existing corporation which is a C corporation to S corporation status or other form of pass-through entity.

[1] Multiple Classes of Stock.

Unlike S corporations which may only have a single class of stock pursuant to Section 1361(b)(1)(D), C corporations can have multiple classes of stock, including preferred stock. However, partnerships and LLCs taxed as partnerships may have different classes of membership interests, including membership interests providing preferred returns. As such, this is only an advantage that a C corporation has with respect to an S corporation and not with respect to a partnership (LLC).

[2] Losses on Small Business Stock.

Generally, losses realized on the sale or other dispositions of corporate stock may only be used to offset capital gains. However, an initial investor whose stock was issued in compliance with the rules of Section 1244 and who later realizes a loss on disposing the stock may reduce his ordinary income (rather than capital gains) by the loss. The ordinary loss treatment, available with respect to both C and S corporation stock, is limited to $50,000 ($100,000 for a married couple filing jointly) annually. The requirements of Section 1244 are as follows:

[a] At the time the stock is issued, the company's total equity capital does not exceed $1 million, taking into account amounts obtained through prior stock issuances;

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102 Section 545(a).

103 For example, Florida imposes a 5-1/2% tax on the taxable income of C corporations, while S corporations are subject to tax only on the amounts subject to the built-in gains tax under IRC Section 1374 and the excess net passive investment income tax under IRC Section 1375. Fla Stat Section 220.02, 220.12, and 220.13.

[b] For the five previous taxable years (or its entire life if in existence less than five years), the company must have either (1) operated at a loss, or (2) derived more than half of its gross receipts from sources other than rents, interests, dividends, annuities, royalties, and dealings in stocks or securities;

[c] The investor must be the initial issuee of the stock (not a transferee) and must be an individual or partnership (not a trust or estate); and

[d] The investor must have paid for the stock in money or other property (other than stock and securities).

[3] Exclusion of Gain on Qualified Small Business Stock.

Section 1202 permits individual shareholders to exclude from gross income 100% of gains they realize from the sale or exchange of "qualified small business stock" held for more than five years. Unlike Section 1244, this provision applies only to C corporations (which must meet certain other requirements). The exclusion is not permitted if, within two years before and after issuance, the company purchased any of its stock from a shareholder or a person related to the shareholder, or if, within one year before and after issuance, the company purchased its stock having a value of more than 5% of the aggregate value of all of outstanding stock (determined as of one year before the purchase). Also, a portion of the gain excluded is a tax-preference item includible in the alternative minimum tax computation. The amount excluded from gross income was 50% when Section 1202 was enacted. Under the American Recovery and Reinvestment Act of 2009, the Section 1202 exclusion was increased to 75% for stock acquired after February 17, 2009 and before January 1, 2011. The Small Business Jobs Act of 2010 increased the exclusion to 100% which was eventually made permanent by the Protecting Americans From Tax Hikes Act ("PATH"). Additionally, the subsequent Acts eliminate any portion of the excluded gain as a tax preference item.

[4] No Shareholder Level Tax on Undistributed Income.

Unlike pass-through entities with respect to which the income of the entity is taxed at the owner level whether distributed or not, there is no shareholder level tax on the undistributed income of a C corporation. Consequently, if a C corporation does not distribute its income to its shareholders, there is no shareholder level tax on such undistributed income. However, in such cases, the C corporation could potentially be subject to the Accumulated Earnings Tax imposed under Section 531 or the Personal Holding Company Tax imposed under Section 541.

[5] No Benefit of Lower Corporate Tax Rates.

For entities that will have lower income, such entities will benefit from the lower corporate tax rates rather than the higher income tax rates applicable to individuals set forth above.

[6] Limitations on Filing Consolidated Returns.

If a corporation directly or indirectly controls one or more other corporations, and the controlling corporation and the controlled corporations together are an "affiliated group," the group may qualify to file a single consolidated corporate income tax return, in place of separate returns for each corporation. The separate incomes of the corporations joining in the consolidated return are totaled. The deductions are similarly totaled. Thereafter, the total or consolidated deductions are subtracted from the total or consolidated income, leaving consolidated taxable income. Next the consolidated tax is computed in the same manner as if the consolidated return were that of a single corporation. Finally, any tax credits are computed, also on a consolidated basis, and deducted from the consolidated tax to arrive at the consolidated corporate tax liability. However, for most corporate groups that file consolidated returns, special rules apply to various items including: intercompany transactions, inventories, basis of assets acquired by one member from another and of intercompany investments, capital gains and losses, operating losses, losses on dispositions of subsidiary stock, and basis of subsidiary stock on its deconsolidation, and earnings and profits available for payment of dividends. S corporations cannot file consolidated returns with C corporations as an S corporation is not an "includible corporation."

[7] Loss of Tax-Free Fringe Benefits.

One disadvantage of operating a corporation as an S corporation rather than as a C corporation, is the inability of certain S corporation shareholders to exclude from their gross incomes the value of certain statutory fringe benefits. Under Section 1372(a), an S corporation is treated as a partnership, and any "2% shareholder" of an S corporation is treated as a partner of such partnership, for purposes of applying the provisions of the Code relating to employee fringe benefits. Section 1372(b) provides that the term "2% shareholder" means any person who actually or constructively (within the meaning of Section 318) owns on any day during the taxable year of the S corporation *more than 2%* of the outstanding stock of such corporation or stock possessing *more than 2%* of the total combined voting power of all stock of such corporation. The effect of this rule is to preclude a 2% shareholder from excluding the value of corporate-provided fringe benefits from income because such benefits are only excludable by "employees," which for purposes of corporate-provided fringe benefits does not include partners of a partnership.[104] Specifically, a 2% shareholder is subject to the following limitations:

- A 2% shareholder may not exclude from his or her income the value of benefits received pursuant to corporate-provided health and accident insurance nor the value of corporate contributions for the cost of corporate-provided health and accident plans under Section 105 and Section 106.

- A 2% shareholder may not exclude from his or her income the value of the first $50,000 of corporate-provided group-term life insurance under Section 79(a).

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[104] See, e.g., Sections 79(a), 105(a), 106 and 119(a). See also, Sections 401(c) and 1402(a).

- A 2% shareholder is not entitled to exclude from his or her income the value of meals and lodging furnished for the convenience of the employer under Section 119.

- A 2% shareholder is not eligible for the benefits of a medical reimbursement plan.

Section 1372 does not define what constitutes employee fringe benefits thereunder. However, the Senate and House Reports[105] specifically list group-term life insurance under Section 79, certain health and accident benefits under Section 105 and 106, and meals and lodging under Section 119 as fringe benefits. It is unclear whether other fringe benefits such as benefits available under a Section 125 cafeteria plan and miscellaneous fringe benefits provided pursuant to Section 132 are subject to Section 1372.

[a] Rev. Rul. 91-26. Although it has been clear that a 2% shareholder could not exclude the value of statutory fringe benefits from his or her income, it was not clear exactly how the IRS would treat the payment of fringe benefits by an S corporation on behalf of its 2% shareholders. The treatment of such payments was clarified in Rev. Rul. 91-26,[106] and in Announcement 92-16.[107]

In Rev. Rul. 91-26, the IRS ruled that accident and health insurance premiums paid for the benefit of a 2% shareholder would be treated the same as guaranteed payments under Section 707(c). As such, health insurance premiums will be deductible by the S corporation under Section 162 (subject to the capitalization rules of Section 263), and includable in the recipient shareholder's gross income under Section 61. Although the amount of such premiums will not be excludable from the recipient shareholder's gross income under Section 106, Rev. Rul. 91-26 also confirms that the deduction under Section 162(l) (which, beginning in 2003, allows self-employed individuals to deduct 100% of the amount paid for accident and health insurance premiums), is available to 2% shareholders.

Because Rev. Rul. 91-26 provides that amounts paid by an S corporation for accident and health insurance covering a 2% shareholder must be reported as wages on such shareholder's Form W-2, Wage and Tax Statement, some concern has been expressed over whether such amounts will be classified as wages for purposes of social security and Medicare taxes. Announcement 92-16 has answered this question by providing that if the requirements of Section 3121(a)(2)(B) are satisfied, amounts paid by an S corporation for accident and health insurance covering a 2% shareholder will *not* be treated as wages for social security or Medicare tax purposes, even though the amounts must be included in wages for income tax withholding purposes on such shareholder's Form W-2. Section 3121(a)(2)(B) excludes from wages certain amounts paid by an employer to or on behalf of an employee for medical and hospitalization expenses in connection with sickness or accident disability. In order for the Section 3121(a)(2)(B) exclusion to apply, the payments must be made under a plan or system for employees and their dependents generally or for a class (or classes) of employees and their dependents.

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105 S. Rep. No. 640, 97th Cong., 2d Sess. 22 and H.R. Rep. No. 826, 97th Cong., 2d Sess. 21.
106 1991-1 C.B. 184.
107 1992-5 I.R.B. 53.

[b] Notice 2008-1. In Notice 2008-1,[108] the IRS set forth rules pursuant to which a "2-percent shareholder" of an S corporation is entitled to the deduction under Section 162(l) for accident and health insurance premiums that are paid or reimbursed by the S corporation and included in the shareholder's income.

The Notice explains that Section 1372(a) generally provides that, for purposes of applying the income tax provisions of the Code relating to fringe benefits, S corporations are treated as partnerships and "2-percent shareholders" are treated as partners. A "2-percent shareholder" is a person that owns more than 2% of the stock of the S corporation or stock representing more than 2% of the voting power of the S corporation's stock on any day during the tax year. Thus, the Notice explains that accident and health insurance premiums paid by an S corporation on behalf of its 2% shareholders for services rendered are treated for income tax purposes like guaranteed payments under Section 707(c). The Notice further explains that, as a general matter, an S corporation can deduct the cost of employee fringe benefits under Section 162(a) if the requirements of the Section are met and that the 2% shareholder is required to include the amount of accident and health insurance premiums in gross income under Section 61(a).

The Notice proceeds to explain that Section 106 contains an exclusion from the gross income of "an employee" for employer-provided coverage under certain accident and health insurance plans, but that a 2% shareholder is not an employee for purposes of Section 106. Thus, the notice indicates that premiums with respect to such plans are not excludable from the 2% shareholder- employee's gross income under Section 106.

Nonetheless, the Notice further indicates that Section 162(l)(1)(A) generally allows an individual who is an employee to take a deduction in computing adjusted gross income for amounts paid during the tax year that constitute medical care for the taxpayer, his or her spouse, and dependents. Citing Rev. Rul. 91-26,[109] the notice concludes that a 2% shareholder-employee in an S corporation who otherwise meets the requirements of Section 162(l) is eligible for the deduction under Section 162(l) if the plan providing medical care is established by the S corporation. In this regard, the notice indicates that a plan providing medical care coverage for the 2% shareholder-employee generally is established by the S corporation if: (1) the S corporation makes the premium payments in the current tax year; or (2) the 2% shareholder makes the premium payment and furnishes proof of such payment to the S corporation which, in turn, reimburses the 2% shareholder in the current tax year.

The Notice further provides that, in order for the 2% shareholder to deduct the amount of accident and health plan premiums paid on his or her behalf by an S corporation, the S corporation must report the premiums paid or reimbursed as wages on the shareholder's Form W-2 for the year. In addition, the shareholder must include in gross income on his or her Form 1040 the premium payments made by the S corporation (or the S corporation's reimbursement of premiums paid by the shareholder).

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[108] 2008-2 I.R.B. 251.
[109] 1991-1 C.B. 184.

The Notice also provides several examples illustrating the application of the above rules. Further, it provides a procedure for taxpayers to file timely amended returns to claim the deduction under Section 162(1).

Finally, the Notice indicates that the IRS does not consider payments of accident and health insurance premiums by S corporations on behalf of 2% shareholder-employees to be distributions for purposes of the "one class of stock" requirement under Section 1361(b)(1)(D).

Since 2% shareholders of S corporations must include the value of statutory fringe benefits in their incomes, whereas C corporation shareholder-employees are not required to include the value of such benefits in their gross incomes, it is somewhat advantageous from a fringe benefit standpoint to operate the service corporation as a C corporation rather than as an S corporation. However, since a 2% shareholder of an S corporation has been permitted to deduct 100% of the amount paid for accident and health insurance premiums since 2003, it has been considerably less disadvantageous to operate as an S corporation rather than as a C corporation from a fringe benefit standpoint since such time.

[8] Eligibility Restrictions.

An S corporation is defined as a "small business corporation" for which an election under Section 1362(a) is in effect for such year.[110] The term "small business corporation" is defined as a "domestic corporation" which is not an "ineligible corporation" and which does not have: (1) more than 100 shareholders; (2) as a shareholder a person (other than an estate or certain types of trusts) who is not an individual; (3) a non-resident alien as a shareholder; and (4) more than one class of stock.[111] The term "domestic corporation" means a corporation that is created or organized in the United States or under the laws of the United States or of any state or territory thereof.[112] The term "ineligible corporation" means any corporation which is a member of an affiliated group as defined in Section 1504, a financial institution, an insurance company, a possessions corporation, or a DISC or former DISC.[113] A husband and wife (and their estates) are treated as one shareholder.[114] Section 1361(c)(2) and (d) prescribe the types of trusts which may be shareholders of an S corporation. For the typical professional corporation, the only eligibility requirement which might pose a problem is the limitation that the S corporation have no more than 100 shareholders.

Some law firms and accounting firms, as well as other professional corporations, will have more than 100 shareholders, and as such, would be precluded from operating their professional corporation as an S corporation. One possible solution to this problem is for each individual member to separately incorporate as an S corporation and form a partnership of S corporations. In this situation, however, it will be necessary to show an independent business purpose for forming the partnership of S corporations, such as limitation of liability, or the IRS may apply Revenue Ruling 77-220[115] to disregard the S elections of the corporate partners.[116]

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[110] Section 1361(a)(1).
[111] Section 1361(b)(1).
[112] Section 7701(a)(3) and (4).
[113] Section 1361(b)(2).
[114] Section 1361(c)(1).
[115] 1977-1 CB 263.
[116] See Ltr Ruls 9026044, 9017057, and 8950066, in which the IRS approved the formation of partnerships of S

[9] Limitations on Taxable Year.

An S corporation must have a "permitted taxable year" which is either a calendar year, a fiscal year for which the corporation establishes a sufficient business purpose, or a fiscal year permitted pursuant to an election under Section 444.[117] Section 444 permits an S corporation to elect a taxable year different from that required under Section 1378 provided that such taxable year does not result in a deferral of greater than three months and provided that the corporation makes the tax payments required under Section 7519 for each year the election is in effect. An S corporation electing under Section 444 must make annual payments to the IRS for approximately the same amount of taxes as the shareholders would have paid if the corporation were on a calendar taxable year. The payments are due on or before May 15 following the calendar year in which the election year begins.[118]

Although C corporations may generally choose any taxable year, if the C corporation meets the definition of a "personal service corporation,"[119] the taxable year of such corporation must be the calendar year unless the corporation establishes a business purpose for having a different period for its taxable year, or elects a fiscal taxable year under Section 444. Section 444 permits a personal service corporation to elect a taxable year other than a required taxable year provided that such taxable year does not result in a deferral of greater than three months and provided that the personal service corporation complies with the Section 280H limitation on the deduction of compensation paid to employee-owners. Consequently, with respect to professional corporations which would (or do) constitute personal service corporations for purposes of the taxable year limitation, such corporations, whether operated as an S corporation or a C corporation, will generally be required to have a calendar taxable year unless a Section 444 election is made by the corporation and it complies with either Section 7519 in the case of an S corporation or Section 280H in the case of a C corporation. As such, there is no clear advantage to operating the service corporation as a C corporation or as an S corporation. Where the service corporation does constitute a personal service corporation for purposes of the taxable year limitation, however, the C corporation offers far more flexibility than does the S corporation.

[10] Tax Costs of Converting From C to S Status or Liquidation.

Although a corporation which converts from C corporation to S corporation status may enjoy considerable tax and other benefits attributable to its S status, the conversion process is fraught with potential pitfalls. These include the potential imposition of the excess passive investment income tax under Section 1375 and the possible termination of the corporation's S election under Section 1362(d), the imposition of the LIFO recapture tax under Section 1363(d), the potential application of the distribution rules applicable to S corporations having subchapter C earnings and profits under Section 1368(c), the loss of net operating loss carryovers under Section 1371(b) and the imposition of the built-in gain tax under Section 1374. Generally, the greatest exposure facing a corporation upon conversion to S corporation status is the imposition of the built-in gain tax under Section 1374. This problem will be especially acute with respect to the corporation that reports its income under the cash method of accounting.

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corporations where an independent business purpose for the formation of the partnerships was present.

117 Section 1378.

118 Section 7519(b).

119 Within the meaning of Section 441(i)(2).

1.06 ADVANTAGES OF OPERATING AS AN LLC VERSUS AN S CORPORATION.

[1] Ability to Make Special Allocations of Profits and Losses to Members.

Unlike S corporations which must make distributions in proportion to the stock ownership of their shareholders in order to avoid the prohibition on having a second class of stock,[120] LLCs taxed as partnerships may make special allocations to their members in accordance with the provisions of Section 704(b).[121] One way for an S corporation to not run afoul of the second class of stock rules would be for it to make its "special allocations" through the payment of different salaries to its shareholders, and then to make any dividend distributions proportionate to the stock ownership of each of its shareholders.

[2] Basis Increase to Members for Indebtedness of the Company.

Unlike shareholders of an S corporation, members of an LLC taxed as a partnership receive outside basis for indebtedness incurred at the entity level.[122] This basis increase is generally beneficial for entities which will initially be operating at a loss so that those losses may be passed through to the owners of the entity and taken as deductions on their individual income tax returns.[123] Section 1366(d)(1) provides that the total amount of losses and deductions taken into account by an S corporation shareholder for any tax year cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. Under Section 704(d), a partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Additionally, to the extent that an S corporation shareholder wants to increase his basis in the S corporation, the loan can be structured as a back-to-back loan.[124]

[3] Step-Up for Inside Basis of Assets.

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[120] Section 1361(b)(1)(D).

[121] In order for special allocations to be respected for tax purposes, such allocations must have substantial economic effect. See Reg. § 1.704-1(b).

[122] Section 752.

[123] Section 1366(d)(1) provides that the total amount of losses and deductions taken into account by an S corporation shareholder for any tax year cannot exceed the sum of the adjusted basis of the shareholder's stock in the S corporation and the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. Under IRC Section 704(d), a partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred.

[124] See Looney and Levitt, "So You Think it's Easy to Obtain Basis Increases for Loans to S Corps? Think Again! Opportunities and Pitfalls in Structuring and Restructuring Loans to S Corporations," 65 NYU Fed Tax Inst, ¶ 15-1 (2007). The ABA Tax Section submitted comments concerning basis increases for back-to-back loans. (*See* "Comments on Qualification of Debt as Indebtedness of the S Corporation to the Shareholders," in a letter dated July 26, 2010 to IRS Commissioner Douglas Shulman (2010 Tax Notes Today 143-19).) Additionally, the S Corporations Committee, as part of a package of proposals to simplify Subchapter S, submitted a proposal to the ABA Tax Section that S corporation shareholders receive a basis increase for corporate-level indebtedness similar to the basis increase partners of partnerships receive under Section 752.

When an S corporation shareholder dies, his stock receives a step-up in basis to fair market value at the date of death, but the inside basis of the S corporation's assets is not changed. Therefore, if the S corporation sells its assets for a gain subsequent to the date of death of a shareholder, the estate or successor shareholder must include in taxable income his proportionate share of the gain. The shareholder will receive an increase in the basis of his stock for the amount of the gain passed through to the shareholder and then presumably will have an offsetting loss on the subsequent liquidation of the corporation or sale of his stock. However, such liquidation or sale may not occur until years later and thus could present a timing problem. Furthermore, some of the gain passed through to the shareholder from the sale of the corporation's assets may be ordinary income (e.g., depreciation recapture), but the loss on the subsequent corporate liquidation or stock sale will be a capital loss. In addition, an individual may deduct only $3,000 per year on account of capital losses in excess of capital gains.

An LLC or partnership can avoid this problem with a Section 754 election. If such an election (which is irrevocable once made) is made or is already in place for an LLC or partnership, upon the death of a member or a partner or upon the sale of an interest in the LLC or partnership, the LLC's or partnership's basis in its assets will be stepped-up to reflect either (i) the excess of the fair market value of the interest at death over the basis in the interest immediately prior to death, or (ii) gain on the sale of the interest, as the case may be.[125] The step-up in inside basis is made only with respect to the transferee member or partner. Section 734 allows a similar adjustment in the case of a liquidation of a member's or partner's interest.

[4] Property Distributions Generally Tax-Free.

Unlike S corporations, a partnership may generally distribute property (as opposed to cash) tax-free to its partners.[126]

[5] Lack of Restrictions on Eligible Members.

As discussed in above, only certain types of shareholders are permitted S corporation shareholders, and an S corporation may not have more than 100 shareholders. On the other hand, an LLC taxed as a partnership has no restrictions whatsoever on the types of members it may have or on the number of members it may have.

[6] Liability Protection (Charging Orders, etc.).

[a] Limited Liability to Members. By statute, members, managers and managing members of an LLC are generally not liable for the debts, obligations or liabilities of the LLC.[127] The liabilities of a member, manager or managing member of an LLC may be expanded through the Operating Agreement or the Articles of Organization.

A manager or managing member can also be held liable for improper distributions made to the members and for transactions in which the manager or managing member obtains an improper personal benefit.[128]

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125 Section 743.
126 Section 731(a)(1) and Section 731(b).
127 See e.g., Fl. Stat. §605.0304(1) and 605.04093.
128 See e.g., Fl. Stat. §§608.4228 and 608.426.

An LLC generally provides the same asset protection to its members for liabilities of the LLC as a corporation offers to its shareholders for liabilities of the corporation. In *Dania Jai-Alai Palace, Inc. v. Sykes,*[129] For example, Fl. Stat. §608.701 provides that in any case in which a party seeks to hold the members of a limited liability company personally responsible for the liabilities or alleging improper actions of the limited liability company (i.e., piercing the LLC veil), the court must apply the same case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced. In *Dania Jai-Alai Palace, Inc. v. Sykes*, the Florida Supreme Court held that the corporate veil could not be pierced without a showing of fraud or an improper purpose, making the limited liability shield of a Florida corporation as among the most difficult to pierce in the United States. Mere disregard of corporate formalities, inadequate capitalization, informal loan transactions and similar poor practices generally will not justify piercing the corporate veil in Florida.[130] Additionally, Florida Statute Section 605.0304(2) expressly provides that the failure of a limited liability company to observe formalities relating to the exercise of its powers or management of its activities and affairs is not a ground for imposing liability on a member or manager of a company for a debt, obligation, or other liability of the company.

Because the laws relating to piercing the corporate veil (as well as the LLC veil) will vary from jurisdiction to jurisdiction, the practitioner should undertake a detailed review and comparison of the LLC statutes of the particular jurisdictions to determine which jurisdiction will best serve a client from a liability protection standpoint.

Additionally, the fact that LLCs are generally subject to less formalities than corporations could either make it easier or harder for a creditor to pierce the LLC veil.§ 19.02[5] below.

[b] Charging Order Protection/Asset Protection Benefits. A membership interest in an LLC is generally considered to be personal property.[131]Unlike creditors of individual shareholders of a corporation, which potentially could foreclose and obtain full ownership of such shareholder's stock in a corporation, individual creditors of an LLC member may generally obtain only a "charging order" against such member's interest in the LLC. A charging order provides a creditor only with the rights of an assignee (to receive distributions to which the debtor-member would otherwise have been entitled), and the LLC may otherwise continue to operate its business without interference from the creditor. The creditor will not be allowed to vote on any issues pertaining to the LLC, inspect or copy business records, nor exercise any of the debtor-member's rights with respect to the management of the business. The creditor as an assignee of a limited liability company interest may generally become a member only if all members consent thereto.[132]

In addition to the charging order constituting a "weak" remedy for the individual creditors of members of the LLC, it has also been argued that a creditor who obtains a charging order may also be subject, as assignee of the membership interest, to the tax liability flowing through from the LLC. Consequently, if an LLC (whether taxed as a partnership or S corporation) earns income which is not distributed to the members, the creditor holding a

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[129] 450 So 2d 1114 (Fla 1984).

[130] See *Hilton Oil Transportation v Oil Transportation Company,* 659 So 2d 1141 (Fla 3d DCA 1995).

[131] See e.g., Fl. Stat. §605.0501.

[132] See e.g., Fl. Stat. §§605.0502 and 605.0503.

charging order may recognize so-called "phantom income" (income without cash). As such, the charging order limitation mandated by state law may provide the advantage of both asset protection for the debtor-member and potentially unfavorable tax treatment to the creditor. This combination of state law benefits (which limit a creditor's remedies to a charging order) and federal tax law detriments (which may subject the holder of the charging order to phantom income) arguably makes the charging order remedy unattractive, and may therefore enable the debtor-member to settle disputes with creditors on more favorable terms than would otherwise be available to a debtor-shareholder.

In *In Re Albright*,[133] however, the Bankruptcy Court interpreting a Colorado charging order statute similar to the Florida statute, held that a creditor of a member of a single-member LLC was ***not*** limited to the charging order remedy. The court found that the charging order limitation was intended to protect the investment of each member from the creditors of every other member, and that no such protection was necessary for a single-member LLC. Consequently, to obtain the desired asset protection benefits of a charging order, the LLC should have at least two members.

On June 24, 2010, the Florida Supreme Court issued its decision in *Shaun Olmstead, et al. v. Federal Trade Commission*,[134] holding that a charging order is not the only remedy available to a judgment creditor of an owner of a single-member LLC under Florida law. This decision allowed a court to order a debtor to surrender his single member LLC and its assets to satisfy a judgment. This decision may have had even broader applications in that the court's analysis compared Florida's LLC and partnership statutes, noting that the applicable Florida partnership statute specifically provides that the charging order is the sole and exclusive remedy to a judgment creditor of a partner. This Florida case created uncertainty in the area of charging orders where a state statute does not clearly make it the sole and exclusive remedy in an LLC setting.

In response to *Olmstead*, the Florida legislature passed House Bill 253 to clarify Florida's law regarding charging orders. The legislation, which amended former Florida Statutes Section 608.433, now Section 605.0503, made clear that "a charging order is the sole and exclusive remedy by which a judgment creditor or a member or member's assignee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company." This makes clear that foreclosure on a member's LLC interest is not an option for a creditor. However, the new Florida law also provides that a charging order is not the sole and exclusive remedy with respect to a single member LLC, if the judgment creditor establishes to the court's satisfaction that distributions under a charging order will not satisfy the judgment within a reasonable period of time, in which event the court could order a foreclosure on the debtor's LLC interest.[135]

Florida Statutes Section 605.0503 makes clear that a court may enter a charging order against the LLC interest of the judgment debtor or the judgment debtor's assignee rights for the unsatisfied amount of the judgment plus interest. This section also provides that a charging order

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[133] 291 Bankruptcy 538 (Bankr D Colo 2003.

[134] 44 So 3d 76 (Fla 2010).

[135] *See* Gassman and Denicolo, "Pass-Through Entities Have Protections in Charging Order Law," 38 Est Plan, No 11, 31 (Nov 2011).

constitutes a lien on the judgment debtor's LLC interest or assignee rights and that, under a charging order, the judgment creditor has only the rights of an assignee to receive any distribution(s) to which the judgment debtor would otherwise have been entitled from the LLC, to the extent of the judgment plus interest. Fl. Stat. § 605.0503(7) clarifies that nothing in Chapter 605 is intended to deprive any member or transferee of the benefit of any exemption law applicable to the transferable interest of the member or transferee.

Fl. Stat. § 605.0503(3) explicitly provides that "[e]xcept as provided in subsections (4) and (5), a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's assignee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company." However, Fl. Stat. § 608.433(6) was added to create an exception to the general rule for interests in single-member LLCs that are not either (i) currently making distributions which can be applied towards satisfaction of the charging order within a reasonable time, or (ii) projected to produce sufficient income which can be applied towards satisfaction of the charging order within a reasonable time. Specifically, a charging order will not be the sole and exclusive remedy by which a judgment creditor may satisfy a judgment if the judgment creditor "establishes to the satisfaction of a court of competent jurisdiction that distributions under a charging order will not satisfy the judgment within a reasonable time." Upon such showing, the court may order the sale of the judgment debtor's interest pursuant to a foreclosure sale. The judgment creditor may make this showing to the court at any time after the entry of the judgment and may do so at the same time that the judgment creditor applies for the entry of a charging order. This exception prevents a debtor from utilizing a single-member LLC as a depository for non-income producing assets, such as raw land, in order to shield such assets from legitimate creditor claims. Notwithstanding subsection (4), the charging order should be the exclusive remedy for a single-member LLC operating a business or holding income-producing assets as long as distributions are anticipated.

The court in *Hage v. Salkin*,[136] interpreted former Fl. Stat. § 608.433 and remanded the case to the bankruptcy court to make a determination on the payment being within a reasonable time period: "In order for a court to order the sale of a judgment debtor's interest in a limited liability company when the judgment debtor is the sole member of that limited liability company, the judgment creditor must first establish that distributions under a charging order will not satisfy the judgment within a reasonable time … the Bankruptcy Court needs to make additional findings under the new law in order to require a foreclosure sale rather than a charging order."

Fl. Stat. § 605.0503(5) describes the rules for foreclosing on a membership interest in a single-member LLC if so ordered. Specifically, if the court orders a foreclosure sale of a judgment debtor's LLC interest or of a charging order lien pursuant to subsection (4), then (i) the purchaser obtains the judgment debtor's entire interest (not merely an assignee interest), (ii) the purchaser becomes the sole member, and (iii) the judgment debtor ceases to be a member of the LLC.

Fl. Stat. § 605.0503(6) expressly provides that the remedy of foreclosure of a judgment debtor's LLC interest or against assignee rights to distributions in the LLC is not available with

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[136] 2012 US Dist LEXIS 29101 (SD Fla Mar 6, 2012).

respect to interests in a multi-member LLC. This reaffirms the position in Fl. Stat. § 608.433(3) that the charging order is the sole and exclusive remedy with respect to multi-member LLCs[137]

It is noteworthy that Nevada and Wyoming recently changed their laws relating to LLCs to make clear that the charging under protection for debtors applies equally to all LLCs, whether owned by one or more members[138]

In *Martin v. Freeman*,[139] the Colorado Court of Appeals allowed the "corporate veil" of an LLC to be pierced, holding the LLC owners in the case personally liable for the debts of their LLC, even though no allegation of fraud was made in the case. In *Martin*, Freeman owned a single member LLC (Tradewinds Group, LLC), which hired Martin to construct an airplane hangar. In 2006, Tradewinds sued Martin for breach of contract and during the pendency of the litigation Tradewinds sold its only significant asset, an airplane, distributing the net sales proceeds to Freeman who used it to pay the litigation expenses of the case. In 2008, the Colorado Court of Appeals reversed a judgment in favor of Tradewinds and remanded with directions to enter a judgment for Martin. Because the proceeds of the sale of Tradewind's assets went to Freeman, the LLC was without any assets. Martin argued to pierce the LLC's liability veil. In a complicated decision, the court allowed such veil to be pierced based on an analysis that focused on whether Freeman used his LLC to defeat a rightful claim. Surprisingly, the court stated in justifying its decision that "wrongful intent or bad faith need not be shown or pierce the LLC veil." Not requiring proof of wrongful conduct may lead to a reduction in the liability shield that was presumably part of Colorado's LLC statute.

The Nevada Supreme Court ruling in *Weddell v. H2O, Inc*.[140] held that in Nevada a charging order entered to provide for a collection remedy of a judgment debtor owning an LLC interest is the exclusive remedy for the debtor under NRS § 86.401(1); citing *Brant v. Krilich*, 835 N.E.2d 582, 592 (Ind. Ct. App. 2005) (holding "that a charging order is the only remedy for a judgment creditor against a member's interest in an LLC." Interpreting a similar Indiana statute). The court also cited *Dixon v. American Industrial Leasing Co.*, 205 S.E.2d 4, 9 (W. Va. 1974); *Green v. Bellerive*, 763 A.2d 252, 261-62 (Md. Ct. Spec. App. 2000).

In *Serio v. Baystate Properties, LLC*,[141] Baystate Properties, LLC ("Baystate") filed a complaint against Vincent Serio, who is the sole member of Serio Investments, LLC ("SMLLC"). Baystate sought to hold Serio personally liable for amounts due to Baystate under a contract with SMLLC. After a bench trial, the circuit court entered judgment in favor of Baystate

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[137] Interestingly, in what appears to be a compromise position, Fl Stat § 605.0503(7) (originally Fl Stat § 608.433(9) was added to House Bill 253 to clarify that certain remedies (under principles of law and equity which affect fraudulent transfers, alter ego, equitable lien, constructive trust or other equitable principles not inconsistent with Fl Stat § 605.0503) continue to exist for a judgment creditor under appropriate circumstances. Accordingly, creditors may continue to seek to set aside the fraudulent transfer of assets to an LLC by a debtor pursuant to the Florida Uniform Fraudulent Transfer Act under Chapter 726 and remedies based on equitable principles, such as alter ego, are not prohibited. This is intended to prevent abuse of the enhanced charging order protection granted under Fl Stat § 605.0503. It is important to note that the remedy of foreclosure would not be permitted as an equitable remedy against interests in a multi-member LLC under the language of subsection (7) because such remedy would be inconsistent with the explicit language of subsection (6).

[138] *See* NRS 86.401 and Wyo Stat § 17-29-503.

[139] 2012 COA 21 (Colo Ct App, Feb 2, 2012).

[140] 271 P3d 743 (2012).

[141] 203 Md App 581, 39 A3d 131 (2012).

against Serio individually. The appeals court reversed and ruled that the SMLLC veil should not be pierced.

There is no discussion in this case of any special rules making it more likely that the veil of a single member LLC can be pierced, even though the major economic asset to be sold to generate revenue for the parties was not owned by the SMLLC but rather by its sole member.

Baystate entered into a contract ("Agreement") with SMLLC to build houses to certain specifications on two lots owned by Serio individually. SMLLC was to provide an escrow account from which Baystate would receive payments under a draw schedule for its work. Upon the sale of the improved lots, SMLLC would pay Baystate an additional $25,000 for each house.

Subsequent addenda to the Agreement obligated SMLLC to pay Baystate an additional $43,638.33. Each addendum referenced Serio personally but Serio revised those references and both parties signed the addenda, with Serio signing as the Managing Member of the SMLLC and not personally. In June of 2007, Serio presented Baystate with a written waiver by Baystate and SMLLC of any claims for personal liability. Baystate and SMLLC executed the waiver.

When Baystate contacted Serio regarding the payments, he was assured that the properties would soon be sold. In fact, the 1901 Hillside Drive Lot had sold on June 29, 2007 for $380,000.00. The 1903 Hillside Drive Lot was sold on October 11, 2007, but, because the buyers subsequently defaulted on a mortgage, Serio received only approximately $20,000.00 on the sale. None of these funds were deposited to the SMLLC bank account. Baystate sued Serio and the SMLLC in October 2007 and received a trial court judgment in 2009.

The trial court ruled the evidence did not support a finding of fraud, but it was "sufficient to establish a paramount equity" and "that there would be an inequitable result involving fundamental fairness" if the "corporate veil" was not pierced because (1) Serio individually owned and sold the lots; (2) Serio gave assurances to Baystate regarding settlement of the lots and payment to Baystate; (3) Serio lied to Baystate about the sale and settlement of the first lot; (4) SMLLC had significant debt and possessed no income besides Serio's personal deposits, making SMLLC "virtually insolvent;" and (5) an escrow account was never established as provided for in the Agreement despite statements by Serio that an escrow account would be created. Additionally, Baystate contracted with SMLLC, a valid, subsisting limited liability company at the time of the transaction. While SMLLC might have been inadequately capitalized, often time possessing just around $100 in cash, there is no evidence that Baystate entered into the Agreement depending on Serio personally to fund its contracts from his personal account or that Baystate took reasonable steps to assure the availability of adequate funding. Baystate was aware that the lots were in Serio's name prior to signing the Agreement. Even though an escrow account that was provided for in the Agreement was not established, there was no evidence that Baystate ever challenged or questioned the failure to establish a funded escrow account. None of the proceeds from the sale of the lots were deposited into the SMLLC account. While unfortunate, the appeals court ruled that the breach is not a valid basis for holding the LLC owner personally liable for the SMLLC's obligations.

Serio made it clear that SMLLC was Baystate's contractual partner for funding the project. SMLLC made payments to Baystate consistent with its obligations under the contract for six months. All payments made to Baystate under the contract were either with checks issued from SMLLC's corporate account, signed by Serio as the "Managing Member," or with cashier checks funded by SMLLC.

The appeals court stated that despite the proclamation in Maryland cases that a court may pierce the corporate veil to enforce a paramount equity, arguments that have urged a piercing of the veil "for reasons other than fraud" have failed in Maryland courts. This Court observed that, "notwithstanding its hint that enforcing a paramount equity might suffice as a reason for piercing the corporate veil, the Court of Appeals has not elaborated upon the meaning of this phrase or applied it in any case of which we are aware."[142]

The appeals court cited corporate veil piercing cases and applied them to this LLC. The court noted that cases establish that the veil is not to be pierced where a corporation is a valid, subsisting corporation that, until it suffered a reversal of fortunes, had substantial assets and business prospects, especially where there is no improper conduct leading to the contract. In a contract with a corporation or other limited liability entity, the contracting party cannot pierce the corporate veil where it knew that it was dealing with a corporation, and it had satisfied itself that the corporation had substantial contracts and assets, that it had two business locations in the state, that it had numerous employees and that it was not a "one man show."[143]

There is a reluctance to disregard the corporate entity in a business-to-business transaction. Moreover, the corporate veil will not be pierced to redress the breach of a contractual obligation in the absence of fraud when the party seeking to pierce the corporate shield has dealt with that corporation in the course of its business on a corporate basis. Referred to as a corporate estoppel, and sometimes assimilated with the doctrine of incorporation de facto, such a course of conduct, particularly in a business-to-business context, precludes a request to pierce the corporate veil.[144]

In sum, the SMLLC fulfilled the contract with Baystate until the collapse of the housing market caused problems. Baystate was an established building contractor who understood and agreed that it was doing business with another limited liability company, as reflected in the Agreement, later addenda, and their continuing course of business. Under the circumstances, the appeals court ruled that the circuit court abused its discretion in finding Serio personally liable for the obligations of SMLLC.

[7] Contracting Around the Duty of Loyalty.

[a] In General. One of the non-tax advantages, in some jurisdictions, of operating as an LLC rather than a corporation for state law purposes, is the ability of the business owners to contract around the so called duty of loyalty. This is important where business owners are engaging in multiple businesses or lines of business, through the use of multiple business entities. Another frequent scenario that gives rise to this issue is when multiple existing businesses form an entity as a joint venture but wish to engage in the same or a similar business as the joint venture. Often the same individuals who manage the joint venture also manage one of the joint venture partners. A non-tax issue that is often overlooked when forming a business entity is whether participating in a business, as a manager, member, partner or director, can preclude one from participating in another business which engages in the same or a similar line

[142] *See also Ramlall v MobilePro Corp*, 202 Md App 20, 31, 30 A3d 1003, 1009 (2011) ("With no precedent approving this extraordinary remedy, we decline to pierce the corporate veil [ ] based on the paramount equity justification.").

[143] *Hildreth v Tidewater Equip Co*, 378 Md 724, 737, 838 A2d 1204, 1211 (2006).

[144] *Turner v Turner*, 147 Md App 350, 426–28, 809 A2d 18 (2002).

of business. The problem arises out of the historic "corporate opportunity doctrine" which is based on a director's and an officer's duty of loyalty to the corporation. It is important to deal in advance with the issues of corporate or business opportunity.

[b] Corporate Opportunity Doctrine. The corporate opportunity doctrine has been defined as follows by the Delaware courts: If there is presented to a corporate officer or director a business opportunity which (i) the corporation is financially able to undertake, (ii) is, from its nature, in the line of the corporation's business and is of practical advantage to it, and (iii) is one in which the corporation has an interest or a reasonable expectancy, and by embracing the opportunity, the self-interest of the officer or director, will be brought into conflict with that of the corporation, the law will not permit him to seize the opportunity for himself. The Court in *Cellular Information Systems, Inc. v. Broz*[145]quoting *Guth v. Loft, Inc.*,[146]went on to state as follows:

> "The corporate opportunity doctrine, as delineated by Guth and its progeny, holds that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimical to his duties to the corporation."

[c] Different State Laws. Different states have different tests that apply to determine theft of corporate opportunity, thus the laws of the relevant state should be reviewed.

[d] Corporations.

For example, for Alabama based businesses, one would normally compare Alabama and Delaware law for this purpose. Both Alabama and Delaware corporate law appear to prohibit advance waivers of the duty of loyalty for corporations. Alabama corporate law requires that officers and directors discharge their duties "in a manner in which he or she reasonably believes to be in the best interests of the corporation."[147] The section of the Alabama Business Corporation Act dealing with what may be in the Articles of Incorporation, allows the elimination of director liability, except for "a breach of the director's duty of loyalty to the corporation or its shareholders."[148] The comment to that code section indicates that it was legislative intent to catalog certain "circumstances in which director liability cannot be eliminated or limited," and notes that the prohibition on exculpation for breach of duty of loyalty is derived from Delaware law[149] in which the Alabama Supreme Court held that whether a manager of an LLC breached its fiduciary duties was determined by looking at the duties imposed on her by Alabama's LLC Act, which fiduciary duties cannot be waived.) Delaware corporate law contains the same prohibition on provisions in the Certificate of Incorporation eliminating or limiting the liability of a director for waiver of the duty of loyalty.[150] Thus, in

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[145] 673 A2d 148, 154 (Del Supr 1996).
[146] 5 A2d 503, 510-511 (Del Supr 1939).
[147] Ala Code § 10-2B-8.42(a) (as to officers) and Ala Code § 10-2B-8.30(a) (as to directors).
[148] Ala Code § 10-2B-2.02(b)(3).
[149] Ala Code § 10-2B-2.02 (Comment 8). *See also Harbison v Strickland*, 900 So. 2d 385 (Ala 2004).
[150] 8 Del Code § 102(b)(7).

both states, it appears that a corporation would be precluded from waiving the corporate opportunity doctrine in advance as a general matter. Delaware implemented changes to the GCL in 2000, however, including Section 122(17) which permits a corporation, by charter amendment or directors' vote, to renounce in advance specific corporate opportunities or types of business.[151] Note that this change seems to be in response to the Chancery Court case of *Siegman v. TriStar Pictures*,[152] which held that a corporation cannot, even by a charter provision otherwise allowable under Del GCL § 102(b)(7), exempt the directors or other fiduciaries from liability for money damages assessed for violating the duty of loyalty.)

[e] Business Purpose Clause. One way to deal with the issue of theft of business opportunity is to narrowly define the "purposes" clause in the articles of incorporation (for a corporation) or the articles of organization for an LLC. If the purpose of the entity is narrowly defined, this would make it harder for someone to argue that a particular opportunity was an opportunity of the entity in question. A limited "purposes" clause would, however, limit the freedom of the entity to engage in a variety of activities and make an ultra vires attack easier if the entity was engaging in activities outside that limited scope.

[f] Fiduciary Duties Often Not Waivable. Where a state LLC statute limits the ability of an LLC's organic documents to eliminate or reduce by agreement certain fiduciary duties that a manager or member may owe to an LLC or its members, the inability to limit such fiduciary duties may become problematic if a member or manager of an LLC is given an opportunity to participate in a business, where such participation might violate such fiduciary duties.

[g] Delaware LLCs. A potential solution to the problem mentioned in § 19.02[3][f] would be to look to Delaware LLC law. The Delaware LLC Act provides that "it is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."[153] 6 Delaware Code 18-1101(c), which was amended in 2013, goes on to provide as follows:

> To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; and provided that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."[154]

Thus, the statute allows the parties to negotiate the extent of their duties, but it is nevertheless important to note that the Delaware legislature amended 6 Delaware Code 18-1104 in 2013 to confirm that, in some circumstances, traditional fiduciary duties apply if they are not

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[151] 6 Del Code § 122(17).

[152] 1989 WL 48746, 15 Del J Corp L 218 (Del Ch 1989).

[153] 6 Del Code 18-1101(b).

[154] Many states, including Missouri, have similar statutory language, allowing LLCs to expand or limit duties, including fiduciary duties, in the operating agreement. *See* R. S. Mo. Section 347.088.

explicitly provided for in an LLC operating agreement.[155] For example, to the extent an LLC operating agreement does not explicitly limit or eliminate duties, the manager of an LLC would owe to the members the traditional fiduciary duties.[156]

Delaware's LLC Act is based on the Delaware Limited Partnership Act, and the provisions between the two acts regarding freedom of contract are "essentially identical."[157] The Delaware Supreme Court has stated that "the basic approach of the Delaware (LLC) Act is to provide members with broad discretion in drafting the Agreement and to furnish default provisions when the members' agreement is silent."[158] The Court further provided that "the commentators observe that only where the agreement is inconsistent with mandatory statutory provisions will the members' agreement be invalidated. Such statutory provisions are likely to be those intended to protect third parties, not necessarily the contracting members."[159] In *The Continental Insurance Company v. Rutledge & Company, Inc.*,[160] the court provided a long analysis of the ability to waive the duty of loyalty in the partnership context. It stated as follows:

> "This dispute highlights a defining tension between contract principles and fiduciary duties. In the limited partnership context, Delaware law resolves this conflict in favor of contract law, rendering fiduciary duties default rules. Consequently, parties to a limited partnership can enter into a contract which diminishes the general partner's fiduciary duties. In order to absolve the general partner from his duties of loyalty or care, the general partner and the limited partners must make their intentions plain. Typically, parties place an explicit clause in the limited partnership agreement to that effect. Where a contract clause amends the fiduciary duties a general partner owes the limited partners, a court will give full force to the terms of the contract."

The court even noted in a footnote that "many opt for the limited partnership form in Delaware precisely in order to embrace this flexibility." It stated that "commentators considering the subject agree that limited partnerships' contract theory based structure provide incentives for parties to opt for the limited partnership over other forms of business organizations."

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155 DE. B. Summ. 2013 Reg Sess. HB 126. The risks of having no duty of loyalty or similar fiduciary duty apply in a Delaware LLC (which can be eliminated in an LLC Agreement of a Delaware LLC) is illustrated by the result of *Touch of Italy Salumeria & Pasticceria v Bascio*, CA, 8602-VCG (January 13, 2014) in which the defendant, LLC member, resigned from the LLC, lied to the LLC about why (said he would not compete) and then opened a competing business. Since there was no restrictive covenant applicable, the court rejected the plaintiff's arguments that attempted to prevent the competition on various grounds, including fraud, implied covenants of good faith and fair dealing, breach of fiduciary duties and equity. These were all rejected since the competitive activity started after the withdrawal from the LLC was completed. This result might have been avoided in states where the duty of loyalty cannot be waived by contract.

156 *See Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, WL 1124451, 8 (Del. Ch. 2009).

157 *Elf Atochem North America, Inc v. Jaffari and Malek, LLC*, 727 A2d 286, 290 (Del Supr 1999).

158 Id. *See Nolan v. Virginia Investment Fund LP*, 833 So 2d 853 (Fla Dist Ct App 2002) (holding that under Delaware law, contract principles preempt fiduciary principles where parties to a limited partnership have made their intentions plain) (quoting *Sonet v. Timber Co*, LP, 722 A.2d 319, 322 (Del Ch 1998)).

159 *Elf* Atochem *North* America*, Inc v Jaffari and Malek*, LLC, 727 A2d 286, 292 (Del Supr 1999).

160 750 A2d 1219, 2000 Del Ch LEXIS 18 (Del Ch), *rehearing denied* 2000 Del Ch LEXIS 40 (Del Ch Feb 15, 2000).

Thus, Delaware courts are allowing partners in limited partnerships to contract around the duty of loyalty in terms of corporate opportunity. Based on the *Elf Atochem* case and the similarity of the Delaware LLC Act to the Delaware Limited Partnership Act. Delaware courts are similarly allowing members of LLCs discretion to limit or eliminate fiduciary duties, including the duty of loyalty, in operating agreements.[161] The converse is also true, in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*,[162] the Delaware Supreme Court held that "a limited partnership agreement may provide for contractually created fiduciary duties substantially mirroring traditional fiduciary duties that apply in the corporation law." The court stated that "if the limited partnership agreement unambiguously provides for fiduciary duties, any claim of a breach of a fiduciary duty must be analyzed generally in terms of the partnership agreement."

In fact, in *CML V, LLC vs. Bax*, No 735, 2010 (Del Sept 2, 2011) (Steele, C.J.), the Delaware Supreme Court, held that a creditor lacks standing to sue an insolvent LLC derivatively, and found that when the Delaware LLC Act says in 18-1002 that a plaintiff in a derivation suit "must be a member or an assignee of a LLC," it really means he must be such a member or assignee. In its decision, the Delaware Supreme Court made clear that ultimately, LLCs and corporations are different; investors can choose to invest in an LLC, which offers one bundle of rights, or in a corporation, which offers an entirely separate bundle of rights. Moreover, in the LLC contract specifically, the General Assembly has espoused its clear intent to allow interested parties to define the contours of their relationship with each other to the maximum extent possible. This opinion reinforces developing Delaware law highlighting the LLC's nature as a contractual entity in contrast to the regulatory nature of the corporation.

[h] Drafting Issues. It is important to draft the agreements to clearly reflect the parties' intentions on how far the parties should be able to go in terms of competition with the entity. If the parties want to be able to compete with the entity in which they are owners or in management, then they should expressly provide for such competition. They may also want to consider the issues of self-dealing and set forth whether this is allowed or not allowed. Because the Delaware courts are allowing this flexibility in terms of LLCs and LPs, it would be advisable to take advantage of this freedom and spell out as clearly as possible what the parties can and cannot do in terms of corporate opportunity and self-interested transactions.

[8] Alienability Issues.

For a variety of reasons including protection of the entity's S election, restricting ownership of an entity to certain groups or classes of owners (e.g., family members, employees, etc.) or compliance with securities laws, an S corporation will in most cases want to regulate the ownership and transfer of its shares or equity interests. Depending upon state law, an LLC may be a better alternative than a corporation for achieving this objective. In general, state corporate statutes permit reasonable restrictions on the transferability of stock, whereas state LLC statutes seem to permit absolute restrictions on transfer.

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[161] *See Freeley v. NHAOCG, LLC*, 62 A.3d 649, 664 (Del Ch No. 28, 2012); *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, WL 1124451, 8 (Del Ch 2009). The Delaware Court of Chancery has noted, however, that the intent of the drafters of the operating agreement to eliminate fiduciary duties must be plain and unambiguous. *See id*.

[162] 817 A2d 160, 163 (Del 2001).

[9] Corporate Formalities.

[a] Piercing the Corporate Veil. Those practitioners who normally represent closely-held and family owned business clients will attest to the fact that many of these clients, who are shrewd at business decisions and execution, simply despise "operational rules" and wish to operate their businesses as their own personal fiefdoms. This attitude plays havoc with and, puts at risk, the state law limited liability which is provided by a properly formed and operated corporation, LLC, LLP, etc. In order to help ensure such limited liability treatment, business owners must address various factors that plaintiffs and their lawyers might use to "pierce the corporate veil" of whatever limited liability entity is used. For example, Alabama case law exemplifies the factual approach that Alabama courts use in determining whether to pierce the corporate veil. One would expect that the factors considered important by Alabama courts would be similar to those considered in other jurisdictions. Some of the factors considered by Alabama courts as a basis for piercing the corporate veil include the following:

- The parent corporation owns all or most of the capital stock of the subsidiary.[163]
- The parent and subsidiary corporation have common directors or officers.[164]
- The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.[165]
- The subsidiary has grossly inadequate capital.[166]
- The parent corporation pays the salaries and other expenses or losses of the subsidiary.[167]
- The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.[168]
- In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.[169]
- The parent corporation uses the property of the subsidiary as its own.[170]

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163 *Duff v Southern Ry Co*, 496 So 2d 760, 763 (Ala 1986).
164 *Id.*
165 *Id.*
166 *Id.*
167 *Id.*
168 496 So 2d 760, 763 (Ala 1986).
169 *Id.*
170 *Id.*

- The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest.[171]

- The formal legal requirements of the subsidiary are not observed.[172]

- The entities use the same offices or mailing address and the same office equipment.[173]

- Failure to complete or properly incorporate the corporation.[174]

- Failure of the shareholders to pay for their shares.[175]

- Failure to conduct meetings of the shareholders or board of directors and to record minutes of same.[176]

- Failure to maintain books and records of the corporation.[177]

- The dominant corporation or individual owns, controls and operates other corporations in a similar manner.[178]

- Dissolving a corporation or creating a corporation to avoid a liability.[179]

- Use by the dominant individual or corporation of the subservient corporation's property.[180]

- Payment of the corporation's debts from another corporation's accounts where both corporations are owned or controlled by the same entity.[181]

- Heavy subsidization of the corporation by the defendant. *Thorn v. C & S Sales Group, Inc.*, 577 So 2d 1264 (Ala 1991).

- Failure to pay the primary shareholders, who are also employees, adequate salaries, or failure to disburse dividends to shareholders.[182]

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[171] *Id.*
[172] *Id.*
[173] *Jefferson County Burial Society v Cotton*, 222 Ala 578, 133 So 256 (1930).
[174] *Christian & Craft Grocery Co v Fruitdale Lumber Co*, 121 Ala 340, 25 So 566 (1899).
[175] *Id.*
[176] *Id.*
[177] *Econ Marketing v Leisure American Resorts, Inc*, 664 So 2d 869 (Ala 1995).
[178] *Dixie Coal Mining & Manufacturing Co v Williams*, 221 Ala 331, 128 So 799 (1930).
[179] *CE Development Co v Kitchens*, 288 Ala 666, 264 So 2d 510 (1972); *Forest Hill Corp v Latter & Blum, Inc*, 249 Ala 23, 29 So 2d 298 (1947).
[180] *Kwick Set Components, Inc v Davidson Industries, Inc*, 411 So 2d 134 (Ala 1982).
[181] *First Health, Inc v Blanton*, 585 So 2d 1331 (Ala 1990).

- Failure of the subservient corporation to obtain a business license, open bank accounts or conduct other ordinary business activities.[183] The corporation is set up as a subterfuge.[184]

- The shareholders do not observe the corporate form.[185]

- The legal requirements of corporate law are not complied with.[186]

- The corporation maintains no corporate records.[187]

- The corporation maintains no corporate bank account.[188]

- The corporation has no employees.[189]

- The corporate and personal funds are intermingled and corporate funds are used for personal purposes.[190]

- An individual drains funds from the corporation.[191]

[b] Corporate Formalities. With respect to businesses operated as S corporations for tax purposes, practitioners have normally used state law corporations formed under some version of the Model Business Corporation Act (MBCA). Alabama's version of the MBCA requires an Alabama corporation to follow various corporate formalities in the manner in which the corporation is operated. Alabama Code Section 10-2B-8.01 provides that the management of a corporation is performed by a board of directors, which represents the interest of passive shareholders and both the directors and the shareholders. Such groups act through the formality of holding of meetings or by the unanimous written consent of such bodies. Corporate bylaws or applicable statutory provisions require certain amounts of notice prior to a meeting being held and for specific quorums to be present before actions can be taken. It is these types of formalities that can result in an attempt by creditors of the entity to pierce the entity's corporate veil.

[c] LLC Formalities. By comparison to the MBCA, the LLC acts of the various states allow for much greater flexibility in the manner in which LLCs are operated. For instance, Alabama's Limited Liability Company Act may be managed by its members or may

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182 *Id.*
183 *Ex parte* AmSouth Bank, 669 So 2d 154 (Ala 1995).
184 *Backus v Watson*, 619 So 2d 1342 (Ala 1993).
185 *Id*.
186 *Id*.
187 *Id*.
188 *Id*.
189 619 So 2d 1342 (Ala 1993).
190 *Id*.
191 *Id*.

have managers who are separate from the members.[192] Moreover, actions by Alabama LLCs do not require formal meetings or that formal notice requirements be followed. In fact, the Alabama LLC Act does not mandate that the members and managers meet at least annually, which is required of Alabama corporations. While decisions are often documented by formal written consents of the Members or the Managers, Alabama LLCs are not required to follow the formalities mandated for Alabama corporations.

- Delaware law allows a Delaware LLC to operate with even less formality by allowing decisions to be made simply by securing the vote of a sufficient number of members (in other words, unanimous consent is not needed for a Delaware LLC to make a decision).[193] Additionally, it should be noted that under Delaware law, it is more difficult to pierce the corporate veil than under Alabama law.

- When comparing the use of Alabama LLCs to Delaware LLCs, many practitioners will conclude that the Delaware statute has many advantages. It would appear logical that a similar analysis would apply to the LLC laws of other states. Accordingly, a review and comparison of the LLC statute of a particular state and Delaware LLC law should be made in determining which state law will serve a client best.

[d] Two Edged Sword of Corporate Formalities. Because corporations are generally subject to more statutory formalities than are LLCs, it can be argued that it would be easier to pierce the veil of a corporation where the corporation has failed to comply with such corporate formalities. On the other hand, the fact that most state laws do not impose such formalities on LLCs may result in the practitioner and his client being "sloppy" with respect to the distinction between the operations of the LLC and its members. Such a failure to observe traditional formalities could make it easier for creditors of the LLC to pierce its veil.

[10] Diversity Jurisdiction.

Another potential non-tax advantage of operating an entity as an LLC rather than as a corporation relates to the ability of an entity to remove a case from state court to federal court.

[a] In General. Diversity jurisdiction is a concept used in civil procedure to refer to the situation in which a U.S. federal district court has jurisdiction to hear a civil case due to the parties being "diverse" in citizenship, generally indicating that they are citizens of different states (corporate parties, and non-U.S. citizens can also be included). The federal law governing diversity jurisdiction states that a case must have an amount in controversy of $75,000 or more before a federal court can hear a case on this basis. Additionally, there are exceptions to diversity jurisdiction for some cases, including probate cases and family law cases, which are almost always handled in state courts. For a federal court to exercise diversity jurisdiction, there must be "complete" diversity between the parties.

[b] Operation of Businesses Through Subsidiaries. In the case of a national organization that conducts business in a number of states, that organization may, for a variety of

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[192] Ala Code § 10-12-22.
[193] Del Code §§ 18-302 and 18-402.

reasons, form a subsidiary organization under the laws of each state in which it conducts business. In the case of a lawsuit filed in state court by a citizen of that state against a subsidiary organization formed in that state, a question arises as to whether there will be diversity jurisdiction to enable the national organization to remove the case from state court to federal court.

[c] Domicile of Corporations Versus LLCs. Under federal law, if the subsidiary is a state law corporation, it will be treated as domiciled in that state (even if it is owned 100% by a corporation that is domiciled in another state), and as such, there will be no diversity jurisdiction. On the other hand, federal law looks to the state in which the owner of an LLC is domiciled in order to determine whether there is diversity jurisdiction. Thus, for example, if a corporation which is headquartered and is otherwise domiciled in Texas forms a Florida LLC of which it owns 100%, a suit by a Florida plaintiff against the LLC would (assuming the other requirements are met) qualify for diversity jurisdiction.

1.07 DISADVANTAGES OF OPERATING AS AN LLC VERSUS AN S CORPORATION.

[1] Employment Tax.

As discussed above, provided an S corporation pays reasonable compensation to its shareholder-employees, there are opportunities for significant employment tax savings by making S corporation distributions to the shareholder-employees.

The self-employment tax ("SE Tax") can be a significant burden on taxpayers as it is imposed on net earnings from self-employment ("NESE") at the rate of 15.3% on the first $127,200 of such net earnings, and 2.9% (or 3.8% on the net investment income of certain individuals as previously discussed above) on amounts in excess of $127,200 for 2017.[194] Excluded from the definition of NESE are certain capital gains, rental income, interest and dividends. Because individuals are entitled to an above the line deduction equal to one-half of the SE Tax paid under Section 164(f), the effective tax rate for the SE Tax is somewhat reduced.

As discussed above, beginning in 2013, the HI portion of the Social Security tax was increased from 2.9% to 3.8% for wages in excess of $250,000 for married individuals filing jointly and in excess of $200,000 for other taxpayers. Additionally, as discussed above, beginning in 2013, taxpayers having modified adjusted gross income in excess of $250,000 in the case of married individuals filing jointly and $200,000 for other taxpayers was subject to the 3.8% Medicare tax on their net investment income.

The SE Tax treatment of general partners is generally understood: each general partner must include as NESE his distributive share of ordinary income (other than the excluded interest, rent and dividends). Section 1402(a)(13) excludes from NESE a limited partner's distributive share of partnership income (other than distributions that are guaranteed payments or compensation for services to the extent that those payments are established to be in the nature of remuneration for those services to the partnership). Accordingly, a general partner's distributive share of income from the partnership normally *will be* treated as NESE, while a limited partner's distributive share of income from the partnership normally *will not be* treated as NESE. The

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[194] Section 1402(a).

legislative history of Section 1402 makes clear that this exception for limited partners was intended to prevent passive investors, who do not perform services, from obtaining social security coverage or coverage under qualified retirement plans. One troubling issue relates to the application of the SE Tax with respect to a limited partner who also serves as a general partner in a partnership. Section 1402's legislative history reflects an intent to apply these rules separately to limited partnership and general partnership interests, even if held by the same partner. The lack of legislative or regulatory clarity has caused the application of rules for limited partners to be difficult.

While multi-member LLCs (which do not elect to be treated as associations taxable as corporations) are treated as partnerships for tax purposes under the Check-the-Box Regulations, the SE Tax issues relating to LLCs and their members are at best unclear. The question to be addressed is whether members of such LLCs (taxed as partnerships) would be treated as limited partners under Section 1402(a)(13), so that their distributive share of LLC income and loss relating to their LLC interest is exempt from SE Tax.

On its face, the language of Section 1402(a)(13) would only exclude from NESE the distributive share of income *of a limited partner* of a partnership. Under such a literal reading, the distributive share of income of any other type or class of partner in the partnership would be considered NESE. Rev. Rul. 58-166,[195] held that the taxpayer's earnings from a working interest in an oil lease was NESE despite the fact that he had limited involvement in the organization.

[a] The 1994 Proposed Regulations. With the advent of LLC statutes in the early 1990's and thereafter, the IRS attempted to address the SE Tax issue with respect to members of LLCs through the promulgation of Prop. Reg. § 1.1402(a)-18 (the "1994 Regulations"). Under the 1994 Regulations, a member of a member-managed LLC would have been treated as a limited partner for purposes of Section 1402(a)(13) if: (i) the member was not a manager of the LLC; (ii) the LLC could have been formed as a limited partnership (rather than as an LLC in the same jurisdiction); and (iii) the member could have qualified as a limited partner in that limited partnership under applicable law.

Accordingly, for manager-managed LLCs, whether a non-manager member's share of the LLC's income would be considered NESE turned on whether such member's interest could have been characterized as a limited partnership interest had the LLC been formed as a limited partnership. This factual determination often proved to be unworkable and depended on several factors, including the amount of the member's participation in the LLC's business operations and the provisions of the LLC Act and Limited Partnership Act of the applicable state.

[b] The 1997 Proposed Regulations. The next attempt by the IRS to address the application of the SE Tax to members of an LLC were the 1997 proposed regulations. Prop. Reg. § 1.1402-2(h) defines a "limited partner" for purposes of the SE Tax as an individual holding an interest in an entity classified as a federal tax partnership unless one of the following exceptions applies:

[i] The individual has personal liability for the debt of or claims against the partnership by reason of being a partner. For this purpose, an individual has personal

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[195] 1958-1 C.B. 224.

liability if the creditor of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from such individual.

[ii] The individual has authority under the law of the jurisdiction in which the partnership is formed to contract on behalf of the partnership.

[iii] The individual participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.

Additionally, there are three exceptions to the general rule set forth in Prop. Reg. § 1.1402-2(h), as follows:

[iv] Under the first exception, an individual who holds more than one class of interest in a partnership and who is not a limited partner under the general definition, may still be treated as a limited partner with respect to a specific class of interest. This exception is satisfied if immediately after the individual acquires the class of interest: (1) persons who are limited partners under the general definition own a substantial continuing interest in the class of interest; and (2) the individual's rights and obligations with respect to that class of interest are identical to the rights and obligations of the specific class held by the partners of that class who satisfy the general definition of a limited partner. Whether the interests of the limited partners in the specific class under the general definition are substantial is determined based on all of the relevant facts and circumstances. There is a safe harbor under which 20% or greater ownership of the specific class is considered substantial. The proposed regulations define class of interest as an interest that grants the holder specific rights and obligations. A separate class exists if the holder's rights and obligations attributable to an interest are different from another holder's rights and obligations. The existence of a guaranteed payment to an individual for services rendered to the partnership is not a factor in determining the rights and obligations of a class of interest.

[v] The second exception applies to an individual who holds only one class of interest. Under this exception, an individual who cannot meet the general definition of limited partner because he or she participates in the partnership's trade or business for more than 500 hours during the partnership's tax year is treated as a limited partner if: (1) persons who are limited partners under the general definition own a substantial continuing interest in the class of interest; and (2) an individual's rights and obligations with respect to that class of interest are identical to the rights and obligations of that specific class held by persons who satisfy the general definition of a limited partner.

[vi] The third exception applies to a service partner in a service partnership and provides that regardless of whether the individual can satisfy the general definition of a limited partner under one of the above-described exceptions, that individual may not be treated as a limited partner. A partnership is a service partnership if substantially all of its activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. A service partner is a partner who provides services to or on behalf of the service partnership's trade or business unless that individual's services are de minimis.

[c] The Moratorium. Immediately following the issuance of the 1997 regulations, significant protests were made. As a result of this significant protest, Congress enacted Section 935 of the Taxpayer Relief Act of 1997,[196] which prohibited the issuance or effectiveness of temporary or final regulations with respect to the definition of a limited partner under Section 1402(a)(13) prior to July 1998. Although the moratorium period has long since passed, no guidance on the definition of a limited partner for self-employment tax purposes under Section 1402(a)(13) has been issued to date.

Accordingly, as a result of the moratorium, there is a dearth of authority with respect to the SE Tax treatment of an LLC member's distributive share of an LLC's income. The only available guidance in existence are several private letter rulings that hold that a member is a partner and that a member's distributive share of partnership income is not excepted from NESE by Section 1402(a)(l3).[197]

While the Congress and the Treasury seem to have reached a deadlock on the self-employment tax issue involving partnerships, the American Bar Association Taxation Section and the AICPA Tax Division developed a legislative proposal to treat members of LLCs that are taxed as partnerships in the same manner as partners of partnerships generally. Simply put, under this proposal, income attributable to capital would be excluded from NESE and income attributable to services would be included. The effect of the proposal is to adopt two safe harbors for determining income attributable to capital, one on an interest-base return of capital, the other on an exclusion for amounts in excess of reasonable compensation for services rendered. This legislative proposal was submitted to Congressman Bill Archer by Paul Sachs on July 6, 1999.[198]

Interestingly, on June 10, 2003, Lucy Clark, a national tax issue specialist in the IRS's examination specialization program, stated that taxpayers may rely on the 1997 regulations. Specifically, she said that "if the taxpayer conforms to the latest set of proposed rules, we generally will not challenge what they do or don't do with regard to self-employment taxes."[199]

[d] The *Thompson* Case. In Thompson *v. United States*,[200] the United States Court of Federal Claims held that *an LLC member could not be treated the same as a limited partner* for purposes of meeting the material participation rules under the passive activity loss limitation rules of Section 469.

The taxpayer-member formed Mountain Air Charter, LLC ("Mountain Air") under the laws of the state of Texas. The taxpayer directly owned a 99% membership interest in Mountain Air and indirectly held the remaining 1% through an S corporation. Mountain Air's Articles of Organization designate the taxpayer-member as its only manager. Because Mountain Air did not elect to be treated as a corporation for federal income tax purposes, by default it was taxed as a partnership.[201] On his 2002 and 2003 individual income tax returns, the taxpayer-member claimed Mountain Air's losses of $1,225,869 and $939,870, respectively. The IRS disallowed

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[196] Pub. L. No. 105-34

[197] See Ltr. Ruls. 9432018, 9452024 and 9525058.

[198] See Tax Notes, July 19, 1999, at 469.

[199] BNA's Daily Tax Report (Friday June 13, 2003), G-3.

[200] 87 F. Cl. 728 (2009).

[201] Reg. § 301.7701-3(b)(1)(i).

the losses because it believed that the taxpayer did not materially participate in the business operations of Mountain Air.

Specifically, the IRS rested its conclusion on Reg. § 1.469-5T, which sets forth the tests for what constitutes taxpayer material participation for purposes of applying the passive activity loss limitation rules of Section 469. The IRS found that Reg. § 1.469-5T "explicitly treats interests in any entity which limits liability as limited partnership interests." Because the taxpayer enjoyed limited liability as a member of his limited liability company (Mountain Air), the IRS concluded that the taxpayer's interest was identical to a limited partnership interest. The taxpayer, on the other hand, argued that his membership interest should not be treated as a limited partnership interest for purposes of the passive activity loss limitation rules. The classification of a membership interest in an LLC as a "limited partnership interest" is important because a limited partner has fewer means by which he can demonstrate his material participation in the business. The parties specifically stipulated that if the taxpayer's membership interest is a limited partnership interest, then the taxpayer cannot demonstrate his material participation in the LLC and Section 469 will limit his losses. Likewise, the parties also stipulated that if the taxpayer's membership interest is *not* a limited partnership interest, then the taxpayer can demonstrate his material participation in the LLC and Section 469 does *not* limit his losses.

The taxpayer simply argued that his interest should not be treated as a limited partnership interest because Mountain Air was *not* a limited partnership. The IRS, on the other hand, argued that it was proper to treat the taxpayer's interest in Mountain Air as a limited partnership interest because the taxpayer elected to have Mountain Air taxed as a partnership for federal income tax purposes and the taxpayer's liability was limited under the laws of the state in which it was organized (Texas).

Based on the plain language of both the statute and the regulations, the court concluded that in order for an interest to be classified as a limited partnership interest the ownership interest must be in an entity that is, in fact, a partnership under state law and not merely taxed as such under the Code. Specifically, the court stated that once Reg. § 1.469-5T(e)(3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply inapplicable to a membership interest in an LLC.

Furthermore, the court found that even if Reg. § 1.469-5T(e)(3) could apply to the taxpayer and the court had to categorize his membership interest as either a limited or general partnership interest, it would best be categorized as a general partner's interest under Reg. § 1.469-5T(e)(3)(ii) since a member in an LLC can actively participate in the management of the LLC (unlike limited partners of a limited partnership).

[e] IRS Action on Decision. In Action on Decision 2010-14,[202] the IRS announced its acquiescence in result only in *Thompson*. In addition to *Thompson*, *Garnett v. Commissioner,*[203] *Gregg v. U.S.*,[204] and *Newell v. Commissioner*,[205] have all ruled against the

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[202] I.R.B. 515 (April 5, 2010).

[203] 132 TC 19 (2009).

[204] 186 F.Supp.2d 1123 (D. Or. 2000).

[205] TC Memo. 2010-23.

IRS's position that an interest in an LLC is a limited partnership interest under Reg. § 1.469-5T(e)(3)(i).

According to Diana Miosi, special counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), the AOD was issued "to get the word out that we're not going to be litigating these cases anymore." Ms. Miosi's remarks were made on March 10, 2010 at a BNA Tax Management luncheon. Additionally, Miosi stated that the string of litigation losses has "gotten our attention," and that "it is important to try to get some guidance out in this area." Finally, Miosi noted that the government has struggled with the issue, not only with respect to Section 469, but also in other areas of the Code as well, such as Section 464 and 736, and the self-employment tax area.

The distinction between membership interests in limited liability companies and limited partnership interests in limited partnerships will be of even greater significance because the new Medicare tax imposed on a partner's distributive share of the operating income of a partnership if the activity of the partnership producing the income is passive with respect to the partner under the passive activity loss limitation rules of Section 469.

[f] Implication of *Thompson* Case on Self-Employment Tax to LLC Members. The issue of whether the members of a multi-member LLC which is taxed as a partnership for federal income tax purposes are treated as general partners or limited partners for purposes of the self-employment tax is unclear at best. Obviously, the IRS could use the same reasoning used against the IRS in the *Thompson, Garnett, Newell* and *Gregg* cases to reach the conclusion that a member's interest in the LLC is *not* equivalent to a limited partner's interest in a limited partnership for purposes of self-employment tax. This would result in members of an LLC being subject to the self-employment tax on their distributive share of the income of an LLC (with certain exceptions for interest, dividends, rent and capital gain). However, on January 14, 2010, Diana Miosi reassured practitioners that they may rely on the proposed 1997 regulations in dealing with the application of the self-employment tax to limited liability companies.[206]

[g] The Robucci Case. In *Robucci v. Commissioner*,[207] the Tax Court applied the two-pronged Moline Properties[208] test to disregard two corporations created by a psychiatrist (on the advice of his accountant) for the purpose of reducing his tax liabilities. The court also imposed an accuracy-related penalty under Section 6662(a) for a substantial understatement of income tax.

The taxpayer met with his advisor to explore the benefits of incorporating his practice, including minimizing taxes. The taxpayer's advisor, who was an attorney and certified public accountant (CPA), had an accounting practice that specialized in small businesses. "Choice of entity planning" for those businesses was a significant part of the advisor's practice.

The taxpayer's advisor recommended an organizational structure designed to transform the taxpayer's sole proprietorship into a limited liability company (LLC) classified as a partnership for federal income tax purposes with the intent of reducing self-employment tax. In

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206 See TNT, Jan. 15, 2010.
207 TCM 2011-19.
208 *Moline Properties v. Commissioner*, 319 U.S. 436, 30 AFTR 1291 (1943).

particular, the LLC would have two members: the taxpayer, who would have a 95% interest, and a newly incorporated personal corporation ("Robucci P.C."), which was designated the manager of the LLC with a 5% interest. The taxpayer's 95% interest was split between an 85% interest as a limited partner and a 10% interest as a general partner. The case does not explain how the LLC could have partners classified as "general partners" and "limited partners." It is unclear why the advisor didn't use a single limited partnership as the choice of entity for the taxpayer. The 85% limited partner interest allegedly represented goodwill, the value of which was determined by the taxpayer's advisor but unsupported by any documentation. A second corporation ("Westphere") was formed for the purpose of providing services in connection with the taxpayer's practice, including its management and tracking its expenses and to creating a group eligible for medical insurance. Westphere charged the LLC "management fees" for its alleged services.

The taxpayer's advisor provided no written explanation of the reason for creating three entities and he never discussed with the taxpayer the basis for the 85%/10% split between his "limited" and "general" partnership interests. The taxpayer did not seek a second opinion from any other CPA or attorney assessing the merits of his advisor's recommendations. There was no valuation in support of the 85% limited partnership interest issued for intangibles, nor was there a written assignment of the tangible or intangible assets of the taxpayer's medical practice to the LLC.

The taxpayer paid self-employment tax only on net income allocated to him as general partner (i.e., 10% of LLC's net income), whereas, as a sole proprietor, he was required to pay self-employment tax on the entire net income from his psychiatric practice.[209]

The court analyzed the facts under the two-prong test of *Moline Properties*. Under this test, a corporation is recognized as a separate legal entity if either:

[i] The purpose of its formation is the equivalent of business activity.

[ii] The incorporation is followed by the carrying on of a business by the corporation.

Under the first prong, the court found that both Robucci P.C. and Westphere were formed solely to reduce the taxpayer's tax liability and not with a business purpose (i.e., there was no equivalent of business activity on corporate formation). With respect to Westphere, the court concluded that its only activity was the equivalent of "taking money from one pocket and putting it into another." Under the second prong of the Moline Properties test, the court found that both Robucci P.C. and Westphere "were, essentially, hollow corporate shells," which lead to the conclusion that "neither carried on a business after incorporation." Thus, the court disregarded both corporations.

Because Robucci P.C. was disregarded for tax purposes, the court found that the LLC had only one owner, the taxpayer. Because no election was made to classify the LLC as a corporation, the LLC was disregarded[210] and its owner was treated as a sole proprietor. Consequently, the taxpayer was treated as a sole proprietor for federal tax purposes, which was his status before formation of the three entities.

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[209] See Section 1401 and 1402.

[210] See Reg. § 301.7701-1 through -3.

[h] The Renkemeyer Case. In *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*,[211] the Tax Court disallowed a law firm's special allocation of business income and held that the firm's attorney partners were liable for self-employment tax on allocations of partnership income related to the law firm's legal practice.

Renkemeyer, Campbell & Weaver, LLP is a Kansas law firm. During the 2004 tax year, the firm's partners included three attorneys and RCGW Investment Management, Inc., a subchapter S corporation that was wholly owned by an Employee Stock Ownership Plan and Trust (the "ESOP") benefiting the three attorneys. The law firm timely filed its partnership tax return for the 2004 tax year, which allocated 87.557% of the law firm's net income to the ESOP. The IRS issued an FPAA for tax years 2000, 2001, and 2002 to the law firm, which:

[i] Disallowed the special allocation to the ESOP and determined that net business income should be reallocated to the partners consistent with the profit and loss sharing percentages reported on the partners' respective Schedules K-1.

[ii] Determined that the partners' distributive shares of the law firm's net business income were subject to self-employment tax.

Although the law firm asserted that the special allocation to the ESOP was proper under the partnership agreement, it could not produce a copy of the partnership agreement for the record. Therefore, the court looked to the partners' respective interests in the partnership to determine whether the special allocation had economic reality. Based on an analysis of relative capital contributions, distribution rights, and profit and loss sharing percentages, the court concluded that the special allocation of the law firm's net business income for the 2004 tax year was improper and should be disallowed.

Section 1402(a) provides several exclusions from the general self-employment tax rule, including an exclusion under Section 1402(a)(13) for the distributive share of any item of income or loss of a limited partner (other than guaranteed payments in the nature of remuneration for services). Because the term "limited partner" is not defined in the statute, the court had to determine whether an attorney partner who provides services in a law firm structured as a limited liability partnership can be treated as a "limited partner" for purposes of the exclusion under Section 1402(a)(13).

The court examined the statute's legislative history, which revealed that the intent of Section 1402(a)(13) was to ensure that individuals who merely invest in a partnership and do not actively participate in the partnership's business operations (which was the archetype of limited partners at the time) do not receive credits toward Social Security coverage. The court determined that the legislative history did not contemplate excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons) from liability for self-employment taxes. Because nearly all of the law firm's revenues were derived from legal services performed by the attorney partners in their capacities as partners, the court determined that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not "earnings which are basically of an investment nature." Therefore, the court held that the attorney partners' distributive shares arising from legal services they performed on behalf of the law firm were subject to self-

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[211] 136 TC 137 (2011).

employment taxes. Because the law firm was formed as a limited liability partnership rather than a limited partnership, it did not actually have "limited" or "general" partners as would a limited partnership.

[i] The Howell Case. In *Howell v. Commissioner*,[212] the Tax Court held a couple liable for self-employment tax under Section 1401 on payments made to the wife by their LLC, finding that the couple could not disavow the reporting position they took on the company's returns by later arguing the payments were partnership distributions rather than guaranteed payments.

In *Howell*, the taxpayers, husband and wife, formed a California limited liability company to provide software and hardware to hospitals consisting of a remote access system that enabled doctors to access hospital records from outside the hospital. When the LLC was first organized, Mr. Howell decided to make Mrs. Howell a member of the LLC rather than himself for various reasons. On the LLC's tax returns, the LLC treated the amounts in issue as guaranteed payments to Mrs. Howell. The taxpayers later argued that these guaranteed payments actually represented distributions from the LLC to Mrs. Howell on which no self-employment tax was owed.

Under Section 1402(a), the term "self-employment income" generally includes an individual's distributive share of income or loss from a trade or business carried on by a partnership of which the individual is a member. While a partner generally must include his distributive share of income in his net earnings from self-employment, Section 1402(a)(13) provides that in certain circumstances, a limited partner may exclude his distributive share of income from net earnings from self-employment. Specifically, Section 1402(a)(13) excludes from the definition of net earnings from self-employment a limited partner's distributive share of partnership income, other than distributions that are guaranteed payments or compensation for services to the extent those payments are established to be in the nature of remuneration for those services.

While multi-member LLCs (which do not elect to be treated as associations taxable as corporations) are treated as partnerships for tax purposes under the check-the-box regulations, application of the self-employment tax to LLC members is at best unclear. The specific question is whether members of such LLCs (taxed as partnerships) should be treated as limited partners under Section 1402(a)(13), so that their distributive share of LLC income and loss is exempt from the self-employment tax, or whether they should be treated as general partners so that their distributive share of LLC income and loss is subject to the self-employment tax.[213]

In its decision, the Tax Court cited its earlier decision in *Renkemeyer*, for the proposition that the legislative history of Section 1402(a)(13) does not contemplate excluding partners who perform services for a partnership in their capacity as partners from liability for self-employment taxes, and that the Section 1402(a)(13) exemption was only meant to exclude from self-employment income the distributive share of individuals who merely invested in the partnership

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[212] TC Memo 2012-303.

[213] The treatment of LLC members for self-employment tax purposes has been an issue the IRS has struggled with for many years. See eg, Prop Reg. § 1.1402(a)(18) (issued in 1994 and later withdrawn); and Prop Reg. § 1.1402-2(h) (issued in 1997 but never finalized).

and who were not actively participating in the partnership's business operations, and whose distributive shares were earnings "basically of an investment nature." Specifically, the court in *Renkemeyer* held that the taxpayers were not limited partners for purposes of Section 1402(a)(13) because the distributive shares received arose from legal services performed on behalf of the law firm by the taxpayers and did not arise as a return on the taxpayers' investment in the law firm.

The Tax Court first found that even if they allowed the taxpayers to disavow the form of the transaction adopted on the LLCs returns (i.e., as guaranteed payments), the taxpayers must offer strong proof to show that the reporting was incorrect, which the taxpayers failed to do.

Additionally, based on the *Renkemeyer* case, the court found that Mrs. Howell performed services for the LLC and was not merely a passive investor, and as such, could not be treated as a limited partner under Section 1402(a)(13).

The *Howell* case, as well as the Tax Court's prior decision in *Renkemeyer*, indicate that it will be difficult for an LLC member to be treated as "limited partner" under Section 1402(a)(13) for purposes of excluding his or her distributive share of the income of the LLC from the self-employment tax any time such member provides services to or on behalf of the LLC and who is characterized other than as a passive investor of the LLC. This should be contrasted with a shareholder of an S corporation who materially participates in the business, where only amounts paid as reasonable salary should be subject to Social Security taxes on such wages, and the shareholder's distributive share of the income of the S corporation and all dividend distributions should be exempt from the self-employment tax and Social Security taxes by reason of Revenue Ruling 59-221[214] and Section 1402(a)(2). An S corporation shareholder who materially participates in an active trade or business carried on by an S corporation should also not be subject to the new tax imposed on net investment income with respect to such shareholder's distributive share of the S corporation's income by virtue of Section 1411(c)(2)(A).[215]

[j] The Riether Case. In *Riether v. Commissioner*,[216] the court rejected on summary judgment a radiologist's and his wife's claim that they were not liable for self-employment tax on their distributive share of income from a diagnostic imaging LLC taxed as a partnership. Although not clear from the facts of the case, presumably all of the income of the diagnostic imaging LLC was attributable to the "facility fee or "technical component" of the imaging services provided by the LLC rather than for professional medical (reading) services.

The LLC actually issued W-2s to the husband and wife showing salaries or wages paid by the LLC to each of them for a portion of the LLC's income. For the balance of the LLC's income, K-ls were issued to the husband and wife on which they did not pay self-employment tax.

Citing Revenue Ruling 69-184,[217] the court stated that the LLC should have treated all of the LLC's income as self-employment income, rather than characterizing some of it as wages.

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[214] 1959-1 CB 225.

[215] The Health Care and Education Reconciliation Act of 2010, HR 4872, P L No 111-152, imposes a 3.8% tax on the lesser of (a) net investment income or (b) the excess of modified adjusted gross income over $250,000 in the case of taxpayers filing a joint return and over $200,000 for other taxpayers. The definition of net investment income is quite expansive for purposes of the new 3.8% tax imposed under IRC Section 1411(a)(1).

[216] 919 F Supp 2d 1140 (DNM 2012).

[217] 1969-1 CB 256.

Specifically, Revenue Ruling 69-184 states that members of a partnership are not employees of the partnership for purposes of self-employment taxes. Rather, a partner who participates in the partnership business is "a self-employed individual." The court found that the LLC's improper treatment of the "wages" income further undermined the taxpayers' simplistic argument that they owed no self-employment taxes simply because they received W-2s.

The taxpayers also argued that the income of the LLC was "unearned income," and as such, was not subject to the self-employment tax. The court stated that simply labeling income as "unearned income" does not exempt such amounts from the self-employment tax. Rather, the court reiterated that the self-employment tax applies to a taxpayer's distributive share of all partnership income with only certain limited exceptions. Citing Section 1402(a)(13), which exempts from the self-employment tax a limited partner's distributive share of income from a limited partnership, and the *Renkemeyer v. Commissioner*[218] case, the court concluded that the taxpayers were not members of a limited partnership, nor did they resemble limited partners, which are those who "lack management powers but enjoy immunity from liability for debts of the partnership." Thus, whether the taxpayers were active or passive in the production of the LLC's earnings, those earnings were self-employment income, subject to the self-employment tax.

[k] <u>CCA 201436049</u>. In CCA 201436049[219] (September 5, 2014), the IRS found that members of a management company LLC ("Management Company") were not "limited partners" within the meaning of Section 1402(a)(13) and therefore were subject to the self-employment tax on their distributive shares of income of Management Company.

Under the facts of the ruling, a limited liability company classified as a partnership for federal tax purposes served as the investment manager for "*Managed Fund,*" a family of investment partnership funds that carry on extensive trading and investing activity (the "Funds"). Management Company generally has full authority and responsibility to manage and control the affairs and business of the Funds. Management Company is primarily responsible for carrying out the extensive market research and trading activity of each of the Funds, and carries on all investment activities, such as the purchasing, managing, restructuring and selling of the Funds' investment assets. Members of Management Company and its employees provide these extensive services to the Funds. Management Company's primary source of income is from fees for providing management services to the Funds. In consideration of Management Company's services, the limited partnership agreements of each of the Funds provide for payment of a quarterly "management fee" from the Funds to Management Company. For the years in issue, Management Company's gross receipts were entirely attributable to management fees for providing services to the Funds, and Management Company's ordinary business income was comprised entirely of income from management fees.

Additionally, in the years in issue, each member of Management Company worked full time for Management Company, performing a wide-range of professional services. Each of the members received a Form W-2 from Management Company for specified wage amounts.

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[218] 136 TC 137 (2011). In *Renkemeyer,* the Tax Court disallowed a law firm's special allocation of business income and held that the firm's attorney partners were liable for self-employment tax on allocations of partnership income related to the law firm's legal practice.

[219] September 5, 2014.

For the years in issue, Management Company treated all of its members as "limited partners" not subject to the self-employment tax on their distributive share of Management Company's income. The only amounts reported as subject to self-employment tax were guaranteed payments representing health insurance premiums and parking benefits paid on behalf of the members by Management Company.

Management Company argued that the "*wage*" amounts reflected on the members' W-2s represent "*reasonable compensation*" for each member of Management Company, and that each member is a limited partner with respect to their distributive share of the income of Management Company. Management Company reasoned that because Management Company has the same role in the business as the S corporation it succeeded, it can continue to apply the same "*reasonable compensation*" wage rules applicable to S corporations. For the reasons discussed below, the IRS rejected Management Company's arguments.

The ruling relies heavily on the legislative history underlying Section 1402(a)(13) and the *Renkemeyer*[220] and *Riether*[221] cases. Section 1402(a)(13) provides that there shall be excluded from self-employment income the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that member for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

The legislative history for the exception in Section 1402(a)(13) clarifies that Congress did not intend to allow service partners in a service partnership acting in the manner of self-employed persons to avoid paying self-employment tax. The ruling goes on to cite the *Renkemeyer* case, in which the Tax Court found that the attorney-partners of an LLP engaged in the practice of law who were lawyers performing services for the LLP were not limited partners within the meaning of Section 1402(a)(13) for purposes of excluding their distributive share of the income of the LLP from the self-employment tax. The Tax Court in *Renkemeyer* went on to provide that the share of the law firm's income did not arise as a return on the partners' investment and were not "*earnings which are basically of an investment nature*."

The ruling also cites the *Riether* case, where the court granted the government's motion for summary judgment on the issue of whether a husband and wife were subject to self-employment tax on their distributive share of income from an LLC. In the *Riether* case, the court concluded that Section 1402(a)(13) only applies to limited partners and not to taxpayers treated as a general partner, "*irrespective of the nature of his membership*." The court went on to find that the taxpayers were not members of a limited partnership, nor did they resemble limited partners, which are those who "*lack management powers but enjoy immunity from liability for debts of the partnership*." The *Riether* case concluded that *whether the taxpayers were active or passive in the production of the LLC's earnings, those earnings were self-employment income subject to the self-employment tax.*

The ruling provides that Management Company's members performed extensive investment and operational management services for Management Company in their capacity as members (i.e., acting in the manner of self-employed persons) and that Management Company

[220] 136 TC 137 (2011).
[221] 919 F Supp 2d 1140 (DNM 2012).

derives its income from the investment management services performed by its members. The IRS concluded that the income earned by the members through Management Company was not income which was "basically of an investment nature" of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to Section 1402(a)(13). Additionally, the IRS stated that like the situation in *Renkemeyer*, the members' earnings were not in the nature of a return on capital investment, even though the members paid more than a nominal amount for their membership interests. Rather, the IRS found that the earnings of each member from Management Company were a direct result of the services rendered on behalf of Management Company by such members. The IRS also stated that similar to *Riether*, Management Company cannot change the character of its members' distributive shares by paying a portion of each member's distributive share as amounts mislabeled as so-called "*wages*," citing Revenue Ruling 69-184.[222]

Finally, the IRS expressly stated that because Management Company was not an S corporation, the "*reasonable compensation*" rules applicable to S corporations did *not* apply to Management Company which was an LLC taxed as a partnership.[223]

[l] CCA 201640014. In CCA 201640014, the IRS rejected the claim of a member of an LLC, who was involved in the management of the LLC's business, that a portion of the member's share of profits of the LLC was not subject to self-employment taxes under the limited partner exclusion of IRC Section 1402(a)(13).

Under the facts of the ruling, the LLC, a partnership for tax purposes owned by the taxpayer, his wife and a trust established by his wife, owned and operated several franchised restaurants. The taxpayer was required by the relevant franchise agreements to devote his full-time and best efforts in the operation of the restaurants.

But to operate the restaurants, the taxpayer appointed a management team to make day to day decisions, with the taxpayer retaining ultimate responsibility for hiring and firing.

The LLC paid guaranteed payments to the taxpayer, and only treated such payments as net earnings for self-employment. The LLC treated the balance of the LLC profits as excludable from self-employment taxes under the limited partner exclusion found in IRC Section 1402(a)(13). The LLC's position was that the LLC's business is capital intensive and that income attributable to invested capital should not be subject to self-employment taxation.

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[222] 1969-1 CB 256. Rev Rul 69-184 expressly provides that a partner of a partnership cannot be treated as an employee for employment tax purposes. Consequently, the court in *Riether* and the IRS in CCA 201436049 found that the LLCs incorrectly issued W-2s to their members since they could not be treated as employees.

[223] Neither a shareholder's distributive share of income passed through from the S corporation under IRC Section 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute net earnings from self-employment subject to the self-employment tax. See Rev Rul 59-221, 1959-1 CB 225, in which the IRS found that an S corporation's income does not constitute net earnings from self-employment for purposes of the self-employment tax, and IRC Section 1402(a)(2), which specifically excludes from the definition of net earnings from self-employment dividends on shares of stock issued by a corporation. Consequently, as long as S corporations pay "reasonable compensation" to their shareholder-employees, the balance of the earnings of an S corporation distributed as dividends should be excluded from employment and Social Security taxes. See, eg, Radtke v US, 895 F2d 1196 (7th Cir 1990); Spicer Accounting, Incorporated v US, 918 F2d 90 (9th Cir 1990); and David E Watson PC v US, 668 F3d 1008 (8th Cir 2012).

In rejecting the taxpayer's position and finding that all of the LLC's profits were subject to the self-employment tax, the IRS cited and discussed *Renkemeyer* and *Riether*, finding that the allocation of some profits to the taxpayer as guaranteed payments did not convert the balance of the LLC's profits to profits attributable to limited partners under IRC Section 1402(a)(13). The Service also rejected the taxpayer's argument that *Brinks, Gilsen* and *Lione* (involving whether bonuses used to zero out a corporation's income were deductible as reasonable compensation) was applicable.

The CCA concluded that a reasonable return on capital was irrelevant to the self-employment tax analysis, that the taxpayer cannot qualify for the limited partner exclusion because, as in *Renkemeyer*, he actively participated in the LLC's business and performed services for the LLC, or as in *Riether*, he exercised management powers over the LLC's business. Finally, the CCA rejected the reasonable compensation theory found in *Brinks*, noting that IRC Section 1402(a)(13) provides an exclusion for limited partners, not for a reasonable return on capital.

[m] Hardy. In *Hardy v. Commissioner*,[224] the court determined that Dr. Hardy's minority interest in a limited liability company operating a surgery center did not have to be grouped with his activity as a plastic surgeon and that the net income from the surgery center was passive and could be offset by Dr. Hardy's other passive losses for purposes of IRC Section 469. Further, the court held that although he performed surgeries at the surgery center, his distributive share of income qualified for the "limited partner" exclusion for net earnings from self-employment under IRC Section 1402(a) (13).

Dr. Hardy is a plastic surgeon specializing in pediatric reconstructive surgery. Initially, he operated on patients at his office or at two local hospitals. He could use his office for surgery only if the procedure required local anesthesia.

In 2001, Dr. Hardy considered the development of his own surgery center because it would provide a cost-efficient alternative to having surgery performed at the hospitals. He actually purchased land for the planned surgery center, but thereafter he was approached by Missoula Bone & Joint Surgery Center, LLC (MBJ) to acquire an interest in MBJ. MBJ was formed by a group of practicing physicians and in 2005 began operating a surgery center. MBJ provided patients with a cost-efficient alternative to having procedures performed at a hospital. MBJ could accommodate procedures that required local or general anesthesia, but complex procedures and procedures that required an overstay stay could only be performed at a hospital.

MBJ was professionally managed. It hired its own employees and did not share any employees with Dr. Hardy's medical practice.

In 2006, Dr. Hardy purchased a 12.5 percent interest in MBJ along with seven other physicians. He paid $163,974 for his interest. He did not manage MBJ or otherwise participate in its day-to-day activities.

Dr. Hardy performed surgeries at MBJ on Mondays and in 2008/2009 performed 11 percent of his surgeries at MBJ. He did not pay rent for utilization of MBJ facilities, with his patients being responsible for all MBJ facility charges. Dr. Hardy performed approximately 50

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[224] TC Memo 2017-16.

percent of his surgeries at his office, 20 percent at MBJ and the remainder at other facilities. Dr. Hardy received distributions from MBJ that were not dependent on the volume of surgeries he performed of MBJ.

For 2006–2010 Dr. Hardy reported the following on his federal income tax returns:

	Passive Losses	MBJ (Active)	MBJ (Passive)
2006	<58,786	279,998	
2007	<60,829>	199,121	
2008	<136,796>		250,494
2009	<98,307>		245,012
2010	<157,187>		270,521

In 2008 and 2009, Dr. Hardy also reported self-employment taxes of $26,745 and $26,530, resulting from the combination of his surgery practice and his distributive share of income from MBJ.

Dr. Hardy's accountant was Walter Kero, a CPA with over 40 years of experience. In 2006/2007, he reported Dr. Hardy's distributive share of income from MBJ as nonpassive. Mr. Kero did this relying on the Schedule K-1 that Dr. Hardy received from MBJ. The Schedule K-1 stated that the income was from a trade or business and included self-employment tax. Mr. Kero did not group Dr. Hardy's interest in MBJ with his medical practice activity, and he did not consider the grouping regulations. Mr. Kero changed his reporting of MBJ in 2008 when he determined that the income form MBJ was passive. He learned that Dr. Hardy was not involved in MBJ's management or liable for its debts. He did not amend the Dr. Hardy's 2006/2007 income tax returns because he did not believe the changes would be material. In reporting Dr. Hardy's 2008 taxes, he included the combined carryover loss of $119,615 from 2006/2007 and offset the total combined passive loss of $256,411 (2006–2008) against Dr. Hardy's distributive share of $250,494 passive income from MBJ.

The IRS disallowed Dr. Hardy's passive loss deductions for 2008–2010 and also disallowed certain deductions claimed for charitable contributions. In addition, the IRS also determined that Dr. Hardy was liable for an IRC Section 6662(a) accuracy-related penalty.

Although the bulk of the court's decision addressed the grouping of activities under IRC Section 469, the court also allowed Dr. Hardy to conform his pleadings to the evidence for purposes of claiming that his distributive share of income was not subject to self-employment tax as reported on his 2008 and 2009 income tax returns. The court exercised its discretion to allow the argument because the evidence on which Dr. Hardy based his motion was admitted at trial and in the parties' stipulation of facts and the IRS addressed the issue in its opening brief.

Under IRC Section 1402(a), net earnings from self-employment means gross income less allowable deductions from a taxpayer's trade or business plus the distributive share (whether or not distributed) of partnership income or loss described in IRC Section 702(a)(8) from a trade or business carried on by a partnership of which he is a member. However, IRC Section 1402(a)(13) excludes from net earnings from self-employment, the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in IRC Section 707(c) to that partner for services actually rendered to or on behalf of the partnership to

the extent that those payments are established to be in the nature of remuneration for those services.

The court held that Dr. Hardy qualified for the limited partner exclusion in IRC Section 1402(a)(13) because he was merely an investor in MBJ. The court relied on the decision in *Renkemeyer, Campbell & Weaver, LLP*[225] where it stated:

> [t]he intent of section 1402(a)(13) was to insure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of Section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes. (footnote omitted).
>
> We held that because the revenues was derived from legal services performed by the partners in their capacity as partners, they were not acting as investors in the law firm. Thus, we held that they were liable for self-employment tax.

The court distinguished Dr. Hardy's situation from *Renkemeyer*. Although Dr. Hardy performed surgeries at MBJ, he was not involved in the operations of MBJ as a business. Unlike the lawyers in *Renkemeyer* who practiced law through the law firm and received distributive shares based on those fees from practicing law, Dr. Hardy's distribution from MBJ was based on fees that patients paid to use its surgical facility, and the patients separately paid Dr. Hardy his fee as a surgeon. Thus, Dr. Hardy's distributive share of income from MBJ was received in his capacity as an investor.

[n] Castigliola.

In Castigliola,[226] the Tax Court held that members of a state-law professional limited liability company (PLLC) were not limited partners for purposes of excluding their distributive shares of net income from self-employment tax. According to the Tax Court, the taxpayers could not be "limited partners" under Section 1402(a) (13) because they were equal participants in the PLLC and therefore, all held positions analogous to general partners in a limited partnership.

Mr. Castigliola, Mr. Banahan, and Mr. Mullen (Taxpayers), were licensed Mississippi attorneys who each owned membership interests in their law firm, a member-managed PLLC. The Taxpayers originally practiced law through a general partnership, but reorganized their law firm as a Mississippi PLLC in 2001. The PLLC did not have a written operating agreement, and there was no evidence indicating that any member's management power was limited in any way. All of the Taxpayers collectively and equally participated in the PLLC decisions regarding making distributions, borrowing money, and hiring employees. Further, each of the Taxpayers supervised associate attorneys and signed PLLC checks. The PLLC's compensation agreement required two types of payments to each member: (1) guaranteed payments-calculated by

[225] 136 TC 137 (2011).

[226] TCM 2017-62 (Apr. 12, 2017).

reference to a survey of local legal salaries; and (2) additional payments of the members' distributive share of net profits in excess of the guaranteed payments. Based on the advice of the PLLC's CPA, the Taxpayers reported the guaranteed payments from the PLLC as self-employment income subject to self-employment, tax but did not pay self-employment tax on the balance of their distributive shares of net profits of the PLLC.

Under Section 1402(a), a partner's self-employment income includes, among other income, their distributive share (whether or not actually distributed) of income or loss from a partnership's trade or business. Further, under Section 1402(a)(13), self-employment income is defined to include guaranteed payments for services rendered to or on behalf of the partnership (as described in Section 707(c)), but does not include a limited partner's distributive share of net income.

The Tax Court addressed whether the Taxpayers, as member-managers of a limited liability company, were "limited partners" entitled to benefit from the self-employment income exclusion under Section 1402(a)(13) for a portion of their distributive shares of the PLLC's income. In addition, the Tax Court addressed whether the Taxpayers were liable for accuracy-related penalties under Section 6662(a).

The Taxpayers contended that the exclusion under Section 1402(a)(13) applied to exclude their distributive shares of income of the PLLC in excess of their guaranteed payments from self-employment income. The IRS argued that the Taxpayers were not limited partners for purposes of the exclusion and, therefore, were subject to self-employment tax on the balance of their distributive shares of income of the PLLC. The Tax Court's main inquiry was whether a member of a member-managed PLLC is functionally equivalent to a limited partner in a limited partnership. The exclusion under Section 1402(a)(13) was originally enacted in 1977 before limited liability companies were widely used or treated as partnerships for federal income tax purposes. Citing Renkemeyer,[227] the Tax Court looked to the definition of limited partners under the uniform limited partnership acts and Mississippi state law. The Tax Court found two primary characteristics in the definitions: (1) limited liability and (2) lack of control of the business. In the present case, the Tax Court found that the member-manager interests held by the Taxpayers vested them with management power over the PLLC and that the Taxpayers all exercised their management power by participating in the control of the PLLC. Therefore, because the Taxpayers participated in the control of the PLLC, their membership interests were not akin to limited partnership interests and the Taxpayers were not eligible to be treated as limited partners for purposes of Section 1402(a)(13).In addition, the Tax Court explained that a limited partnership must have at least one general partner that is in control of a business. In the present case, all of the Taxpayers "participated equally in all decisions and had substantially identical relationships with the PLLC." Therefore, each Taxpayer must have held a role analogous to that of a general partner in a limited partnership. This position was bolstered by the PLLC's history of operating as a general partnership before the 2001 reorganization and because no evidence was presented that the management of the business changed after the reorganization. Accordingly, since the Taxpayers were not eligible to be treated as "limited partners" for purposes of Section 1402(a) (13), the Tax Court held that the Taxpayers' distributive shares of the PLLC's income were subject to self-employment taxes.

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[227] Renkemeyer, 136 TC 137 (2011).

The IRS also contended that the Taxpayers were liable for accuracy-related penalties because they incurred underpayments due to substantial understatements of income tax. The Tax Court rejected this argument and concluded that the Taxpayers were not liable for any penalties under Section 6662(a) because they acted with reasonable cause and good faith. The Tax Court found it important that the Taxpayers reasonably relied on the advice of their CPA; that there were no regulations, administrative, or judicial guidance during the years at issue defining "limited partner"; and that the members adopted a fairly conservative (although incorrect) reporting position under which they remitted self-employment taxes on the reasonable guaranteed payments determined by reference to salary surveys.

[2] Partners Cannot be Employees.

On June 13, 2014, Curtis Wilson, IRS Associate Chief Counsel (Passthroughs and Special Industries) stated that he is concerned about the rumored use of a disregarded entity to enable a partner to be treated as an employee for withholding purposes.[228] Under the purported structure, a partnership creates a wholly-owned entity that is disregarded for federal income tax purposes, and has the partners of the partnership become employees of the disregarded entity, which for employment tax purposes, is treated as the employer having its own employer identification number and subject to Form W-2 withholding. Wilson stated that the IRS is looking at this issue but that if the use of a disregarded entity works, "it makes it pretty easy to get around what would otherwise be the general rule, and so … we think it's a stretch." The general rule Wilson is referring to is that contained in Revenue Ruling 69-184,[229] which states that an individual cannot both be an employee and a partner of the same partnership.

Additionally, Clifford Warren, Special Counsel to the IRS Associate Chief Counsel (Passthroughs and Special Industries) cited the recent *Riether*[230] case which confirmed the holding in Revenue Ruling 69-184 that if an individual is a partner, he cannot be an employee of the partnership. Based on the *Riether* case confirmation of Revenue Ruling 69-184 and on the purported use of disregarded entities as a way to treat a partner of a partnership as an employee,

In 2016, the Service issued Temporary Regulation §301.7701-2T(e)(8)(i)[231] and an identical proposed regulation.[232] Section 301.7701-2(c)(2)(i) states that, except as otherwise provided, a business entity that has a single owner and is not a corporation under §301.7701-2(b) is disregarded as an entity separate from its owner (a disregarded entity). However, §301.7701-2(c)(2)(iv)(B) provides that an entity that is a disregarded entity is treated as a corporation for purposes of employment taxes imposed under subtitle C of the Internal Revenue Code (Code). Therefore, the disregarded entity, rather than the owner, is considered to be the employer of the entity's employees for purposes of employment taxes imposed by subtitle C.

This raises the question of whether in the case of an LLC owned by a partnership and treated as a disregarded entity under the check the box rules, the partners of the partnership may be treated as employees of the disregarded entity, receiving a W-2 and obtaining certain tax

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228 See Elliot, "IRS Concerned About Dual Partner/Employee Workaround," 2014 TNT 115-8 (June 16, 2014).
229 1969-1 CB 256.
230 919 F Supp 2d 1140 (DNM 2012). For a discussion of the *Riether* case, see Klein and Looney, "Income from Diagnostic Imaging Subject to Self-Employment Tax," 16 BET 46 (January/February 2014).
231 TD 9766.
232 REG-114307-15.

beneficial fringe benefits open to employees but not partners. It was argued that the disregarded entity should be respected for payroll tax purposes under Reg. §301.7701-2(c)(2)(iv)(C)(2) . The proposed and temporary regulations address this issue with the following statement in the Preamble:

> [U]nder this reading, which was not intended, some taxpayers have permitted partners to participate in certain tax-favored employee benefit plans. The Treasury Department and the IRS note that the regulations did not create a distinction between a disregarded entity owned by an individual (that is, a sole proprietorship) and a disregarded entity owned by a partnership in the application of the self-employment tax rule. Rather, §301.7701-2(c)(2)(iv)(C)(2) provides that the general rule of §301.7701-2(c)(2)(i) applies for self-employment tax purposes for any owner of a disregarded entity without carving out an exception regarding a partnership that owns such a disregarded entity. In addition, the Treasury Department and the IRS do not believe that the regulations alter the holding of Rev. Rul. 69-184, 1969-1 CB 256, which provides that: (1) bona fide members of a partnership are not employees of the partnership within the meaning of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954), and (2) such a partner who devotes time and energy in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

Specifically, the new regulations adds the following language to the end of Reg. §301.7701-2T(c)(2)(iv)(C)(2):

> Also, if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2 is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2.

Transitional rules are provided for existing structures:

> In order to allow adequate time for partnerships to make necessary payroll and benefit plan adjustments, these temporary regulations will apply on the later of: (1) August 1, 2016, or (2) the first day of the latest-starting plan year following May 4, 2019, of an affected plan (based on the plans adopted before, and the plan years in effect as of, May 4, 2019) sponsored by an entity that is disregarded as an entity separate from its owner for any purpose under §301.7701-2. For these purposes, an affected plan includes any qualified plan, health plan, or section 125

cafeteria plan if the plan benefits participants whose employment status is affected by these regulations. For rules that apply before the applicability date of these regulations, see 26 CFR part 301 revised as of April 1, 2016.

[3] Reorganization Provisions.

[a] Tax-Free Reorganizations are Limited to Corporations. By complying with the reorganization provisions prescribed under Section 368(a), owners of an S corporation can effectively "sell" their S corporation to another corporation and receive stock in that corporation, including preferred stock, without incurring any federal income tax.[233]

[b] Partnerships Not Eligible for Tax-Free Reorganization Treatment. In contrast, a similar transaction undertaken by a partnership would result in a taxable transaction.

[i] Incorporation of the Partnership. A possible way to address the "corporate" requirements of Section 368 is to incorporate the partnership.[234] The IRS will analyze the tax effects of the partnership incorporation in accordance with its form.[235]

[ii] Liabilities in Excess of Basis. Under Section 357(c), if the partnership's liabilities exceed the aggregate basis of the transferred assets, the transferor recognizes gain equal to the amount of such excess.

[iii] Step-Transaction. In many cases, the desirability of incorporating the LLC/partnership may not become apparent until a potential suitor and transaction have materialized. These situations are problematic from the taxpayer's perspective because they are subject to attack, particularly under step-transaction analysis or Court Holding analysis.[236]

In Rev. Rul. 70-140,[237] A, an individual, owned two businesses, one of which was owned by X, a wholly owned corporation, and a similar business operated as a sole proprietorship. Pursuant to an agreement between A and Y, an unrelated corporation, A transferred the sole proprietorship to X, for additional stock and then transferred all of his X stock to Y solely in exchange for Y voting stock which was widely held. The ruling holds the steps were part of a prearranged plan and that the transfer of the sole proprietorship to X would not be respected since it was merely a transitory step without substance for tax purposes. The transaction was

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[233] See *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (Acquisition for cash (representing 62% of the exchange consideration) and non-voting preferred stock (representing 38% of the exchange consideration) qualified as a reorganization).

[234] See Rev. Rul. 84-111, 1984-2 C.B. 88 (which addresses three different forms for incorporating a partnership: (1) transfer by partnership of its assets and liabilities to corporation in exchange for stock of corporation followed by liquidation of partnership and distribution of stock to partners; (2) liquidation of partnership followed by transfer by partners of assets and liabilities received from liquidating partnership to corporation in exchange for stock of corporation; and (3) transfer by partners of their partnership interests to corporation in exchange for stock of corporation with partnership terminating upon transfer).

[235] See also Rev. Rul. 2004-59, 2004-24 IRC 1050 (conversion of partnership to corporation utilizing state formless conversion statute treated as partnership contributing all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter liquidating and distributing the stock of the corporation to its partners), and Reg. §301.7701-3(g)(1)(i) (check the box incorporation treated as partnership contributing its assets to corporation in exchange for stock of corporation and then liquidating).

[236] Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

[237] 1970-1 C.B. 73.

recast as a taxable sale of the sole proprietorship assets to Y, followed by Y's drop down of the assets to X.[238]

[4] Cancellation of Debt/Insolvency.

[a] In General. Although the analysis is complicated, in many cases involving a financially distressed entity, the tax consequences to an owner of an S corporation may be more favorable than that of an owner of a partnership.

[b] S Corporation. Under Section 108(d)(7), subsections (a) (exclusion from gross income), (b) (reduction of tax attributes), (c) treatment of discharge of qualified real property business indebtedness and (g) qualified farm indebtedness, of Section 108 are applied at the corporate level. Thus, for example, for purposes of the insolvency exclusion under Section 108(a)(1)(B), solvency is determined at the level of the S corporation.

[c] Partnership. Under Section 108(d)(6), subsections (a), (b), (c) and (g) of Section 108 are applied at the partner level.[239]

[5] Audit Procedures.

[a] S Corporation Audit Procedures.

[i] After December 31, 1996. Effective for tax years beginning after December 31, 1996, the entity audit provisions previously applicable to S corporations have been repealed.[240] In place of the entity-level audit rules, new rules require consistency between the returns of the S corporation and its shareholders.[241] Under these rules, a shareholder in an S corporation is required to report on his or her return each subchapter S item in the same manner as the corporation.[242] For these purposes, the term "subchapter S items" means any item of an S corporation to the extent that the treasury regulations provide that such item is more appropriately determined at the corporate level, than at the shareholder level.[243]

If the shareholder's reporting is inconsistent with the corporation's reporting, or if the corporation has not filed a return, the shareholder may file a statement with the Service identifying the inconsistency and report in such inconsistent manner.[244] If the shareholder fails to notify the Service of inconsistent treatment, any adjustment required to make his reporting consistent with the corporation's treatment of the items shall be treated as arising out of a mathematical or clerical error.[245] In such a case, the Service may assess and collect tax based on consistent adjustments without following the normal 90-day notice of deficiency procedures, and the normal abatement procedures available for challenges of math or clerical errors are not applicable.[246]

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238 See also West Coast Marketing Corp. v. Commissioner, 46 TC 32 (1966).

239 See Merkel v. Commissioner, 192 F.3d 844 (9th Cir. 1999).

240 Small Business Job Protection Act of 1996, Pub L No 104-737, 104th Cong, 2d Sess, § 1307(c)(1) (Aug 20, 1996).

241 HR 3448, 104th Cong, 2d Sess (1996), IRC § 1307(c)(2) and IRC §§ 6037(c)(1)–(4).

242 IRC § 6037(c)(1).

243 IRC § 6037(c)(4).

244 IRC § 6037(c)(2).

245 IRC § 6037(c)(3); *see* IRC § 6213(b)(1).

246 IRC § 6037(c)(3); *see* IRC § 6213(b)(1).

The repeal of the corporate-level audit procedures simplifies the audit process for most S shareholders. It also eliminates the problems arising from one shareholder being designated as tax matter shareholder and making decisions on behalf of other shareholders.

The Service must challenge the proper treatment of an item on an S corporation's return only by auditing a shareholder's return. Since, in many cases, not all shareholders are audited, the shareholder-level approach to tax disputes can result in inconsistent treatment of the same item on different shareholder's returns.

Example: Alpha, Inc., a calendar-year S corporation with three equal shareholders, *A, B,* and *C,* reported gain on a sale of property as capital gain on its Form 1120S for 2011. If the Service desired to dispute the characterization of the sales proceeds as capital gain, it has to audit and adjust each shareholder's tax return. If the Service commenced the audit of *A*'s, but not *B*'s or *C*'s, return within the applicable statute of limitations,[247] any additional tax liability resulting from the audit of *A*'s return could not be assessed against *B* or *C*.[248]

PRACTICE NOTE:

In *Bufferd v. Commissioner*,[249] The Supreme Court held that the limitations period for assessing the tax liability for S corporation items runs from the date on which the shareholder's return is filed. The fact that the S corporation's statute of limitations had expired did not bar the Service's assessment. The *Bufferd* decision involved a tax year prior to the enactment of the unified S corporation level audit procedures of IRC Section 6241. Therefore, the *Bufferd* decision has continuing application.

The Internal Revenue Manual (IRM) cautions the following to examiners:

> Since S corporations are no longer subject to TEFRA procedures, the statutes are generally controlled at the shareholder level, so 100% of the shareholder statutes should be reviewed and protected. In *Bufferd v. Commissioner* 506 US 523, 113 S Ct 927 the Tax Court held that the limitation period for assessing the tax liability of a shareholder in a Subchapter S corporation who claimed pass-through items, began to run from the filing date of the individual return and not the filing date of the corporate return.[250]

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[247] IRC § 6501(a) provides a three-year statute of limitations within which the Service must assess a tax deficiency or be forever barred; unless the deficiency results from a 25 percent omission of gross income, in which case, a six-year statute applies (IRC § 6501(e)) or, in event of fraud or failure to file, in which case no statute of limitations applies (IRC § 6501(c)).

[248] But see CCA 20128026 which determines that IRC § 6501(c)(1) does not apply to hold open the period for assessment of income tax against an innocent S corporation shareholder who underreported income resulting from an S corporation return that fraudulently overstated deductions.

[249] 506 US 523 (1993), *affg* 952 F2d 675 (2d Cir 1992).

[250] IRM 4.31.5.7.1, paragraph 1 (2010). However, in CCA 201409005 an S corporation filed an amended return after the applicable limitations period had run. The amended return reported no change in tax but was filed to adjust certain flow-through items that would impact an individual shareholder's return. The shareholder then filed a Form 1040X which the IRS disallowed due to the fact the amended Form 1120S was filed outside the limitations period of the S corporation. Acknowledging that the period of limitations for filing individual and S corporation returns differ and that under *Bufferd* an individual shareholder's period of limitations under IRC § 6501 and IRC § 6511 are not controlled by when the S corporation's Form 1120S is filed, Chief Counsel found that there is no authority to require

[ii] Prior to January 1, 1997. For taxable years beginning before January 1, 1997, IRC Section 6241 required that the tax treatment of any "subchapter S item" must be determined at a unified corporate level proceeding, rather than at the shareholder level.[251] A subchapter S item was generally defined as any item that "is more appropriately determined at the corporate level than at the shareholder level."[252] The nature and definition of a subchapter S item are discussed in detail in § 11.04 below.

Under the unified S corporation level audit procedures, all audits took place at the corporate level, and the statute of limitations was determined at the corporate level rather than at the shareholder level. There was an exception to the unified procedures for a "small S corporation," which was defined as "an S corporation with 5 or fewer shareholders, each of whom is a natural person or an estate."[253]

[iii] Tax Consistency Requirement and the Computational Adjustment. An S shareholder must report all subchapter S items on his tax return in the same manner as they are reported by the corporation on its Form 1120S, unless he notifies the Service of inconsistent treatment.[254] The Service cannot challenge the corporation's method of reporting when auditing a shareholder's return. It must contest any subchapter S item by an audit of the S corporation.

[iv] Subchapter S Item Defined. The consistency requirements apply only to subchapter S items. A subchapter S item is any item of an S corporation to the extent that regulations prescribed by the Secretary provide that such item is more appropriately determined at the corporate level than at the shareholder level.[255] Given that the Secretary has not promulgated regulations treating S corporation items, the pre-1997 code provisions and regulations may provide some guidance. Under pre-1997 law, the criterion for identifying a subchapter S item was that the S corporation, in maintaining the books and records required by the Code, would normally have the information necessary to make the determination.[256] If the S corporation failed to make a determination (e.g., because it did not maintain proper books and records), this failure did not prevent an item from being a subchapter S item.[257]

Under pre-1997 law, all factors that were required to determine the existence, amount, or character of an S corporation's income, gain, loss, deduction, or credit are considered subchapter S items. The following are examples of these factors:

1) which methods of accounting are being used;

2) what taxable year is being used;

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the IRS to process, or to prohibit the IRS from processing the S corporation's amended Form 1120S, and advised the IRS to make a business decision based on a factual analysis as to whether to process the amended Form 1120S.

[251] Temp Treas Reg § 301.6241-1T.

[252] IRC § 6245; Temp Treas Reg § 301.6245-1T(a). *Note:* The Small Business Jobs Creation Act of 1996 eliminated unified corporate level audit procedures for S corporations.

[253] Temp Treas Reg § 301.6241-1T.

[254] IRC § 6037(c)(1).

[255] IRC § 6037(c)(4).

[256] *Id.*

[257] Temp Treas Reg § 301.6245-1T(c)(2).

3) which inventory methods are being used;

4) what corporate tax elections are being made;

5) whether property is treated as a capital asset, Section 1231 property, or inventory;

6) whether items that are currently deductible must be capitalized;

7) whether corporate activities have been engaged in with the intent to make a profit for purposes of IRC Section 183;

8) whether the corporation qualified for the credit for increasing research activities under IRC Section 41; and

9) whether the corporation qualified for credit for clinical testing for rare disease under IRC Section 28.

[b] Bipartisan Budget Act Revamps Partnership Audit Procedures.

[i] Overview. On November 2, 2015, the Bipartisan Budget Act of 2015[258] (the Act) became law. The Act radically alters the audit procedures for partnerships. In this respect, Act Section 1101 (Partnership Audits and Adjustments) repeals the TEFRA Partnership Audit Rules (IRC Sections 6221 through 6234), the electing large partnership rules (IRC Sections 771 through 777), and the assessment rules relating to electing large partnerships (IRC Sections 6240 through 6242) and generally replaces those provisions with a scheme under which the partnership entity will be liable for imputed underpayments determined by netting all adjustments of items of income, gain, loss, deduction, or credit determined at the partnership level and taxing the net adjustment at the highest rate of tax under IRC Section 1 or IRC Section 11 for the reviewed year.

PRACTICE NOTE:

Because of the complexities of the Act, many practitioners and their clients may choose S Corporation status over partnership status to avoid such complexity, especially where the benefits of subchapter K are minimal.

[ii] Long Lead Time. The amendments to the current partnership audit regime generally will apply to partnership returns for tax years beginning after December 31, 2017.[259] This long lead time is necessary because the new provisions contain numerous disconnects that requires a massive amount of regulatory guidance[260] to implement and, most significantly, will require much thought about the effects of these provisions on partnerships in the real world, including the formation, operation, and disposition of partnerships (and the acquisition, holding, and disposition of interests therein).

The IRS attempted to flesh out how the new partnership audit regime will work by issuing 277 pages of proposed regulations, including procedures for electing out of the regime, filing administrative

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[258] Pub L No 114-74, 114th Cong (Nov 2, 2015).

[259] The Bipartisan Budget Act of 2015, Pub L No 114-74, 114th Cong, § 1101(g)(1) (Nov 2, 2015).

[260] *See* REG-136118-15.

requests, and determining amounts owed by a partnership or its partners with respect to adjustments arising out of a partnership examination. Such proposed regulations also address the scope of the new partnership audit regime, provides definitions and rules regarding its application, and the designation of a partnership representative. The proposed regulations were originally issued in January, 2017, but were withdrawn as part of a regulatory freeze imposed by the Trump administration. The proposed regulations were eventually reissued on June 13, 2017 (REG-136118-15) and are essentially identical to the previously withdrawn regulations.

It is noteworthy that both the American Bar Association Section of Taxation and the AICPA have formally requested a delay in the effective date on the new partnership audit regime. Moreover, the Tax Technical Corrections Act of 2016, introduced (on December 6, 2016) in the 114th Congress as H.R. 64392 and S. 35063, was proposed to provide improvements to the regime and would likely have a significant impact on how the regime would work.

[iii] Determinations of Imputed Underpayment. Under IRC Section 6221 adjustments of partnership items of income, gain, loss, deduction, or credit, and a partner's distributive share thereof, will be determined, and any tax attributable thereto will be *assessed and collected*, and the applicability of any penalty, addition to tax or additional amount relating to such adjustments will be determined and collected, at the partnership level.

IRC Section 6225(b) addresses the determination of an imputed underpayment. An imputed underpayment is calculated by netting all items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of tax in effect for the reviewed year under IRC Section 1, or IRC Section 11. The reviewed year is the partnership tax year to which the items being adjusted relate.[261] Any adjustment to an item of credit is taken into account as an increase or decrease in the amount of the tax payable by the partnership. If an adjustment reallocates the distributive share of an item from one partner to another partner, only the increases in items of income or gain and decreases in items of deduction, loss, or credit are taken into account.[262]

The partnership must pay any imputed underpayment in the adjustment year. The adjustment year is the partnership tax year in which (1) in the case of an adjustment pursuant to a court proceeding brought under IRC Section 6234, the decision becomes final, (2) in the case of an administrative adjustment request under IRC Section 6227, such request is made, or (3) in any other case, notice of final partnership adjustment is mailed under IRC Section 6231.[263] However, if the adjustment does not result in an imputed underpayment, the partnership takes the adjustment into account in the adjustment year as a reduction in the partnership's non-separately stated income (or an increase in any non-separately stated loss), or, with respect to a credit, as a separately stated item.[264]

IRC Section 6225(c)(1) directs the IRS to establish procedures to modify the calculation of the underpayment consistent with the provisions in Subsection (c). This includes adjusting the underpayment by taking into account adjustments reported by a partner on an amended return filed for a year that includes the reviewed year and that takes into account all adjustments that are allocable to such partner. With respect to items that relate to allocations of a distributive share, all partners affected by such adjustment must file such amended returns. The modification procedures must also take into account allocations to a partner that would not owe any tax due to its status as a tax-exempt entity. Also, the

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[261] IRC § 6225(d)(1).
[262] IRC § 6225(b)(2).
[263] IRC § 6225(d)(2).
[264] IRC § 6225(a)(2).

procedures must address tax that would be calculated at a lower rate with respect to the portion of an underpayment that is allocable, in the case of ordinary income, to a C corporation, and in the case of a capital gain or qualified dividend, to an individual. For this purpose, an S corporation is treated as an individual.[265] The IRS is also given authority through regulations or guidance to provide for additional procedures to modify imputed underpayment amounts.

IRC Section 6225(c)(6) requires that anything that is required to be submitted in connection with the modification must be submitted no later than 270 days after the notice of the proposed partnership adjustment is mailed under IRC Section 6231, unless the Service consents to extend this period. This limitation appears problematic because the submission period for modification may expire while the partnership is still considering whether it will seek judicial review of any proposed partnership adjustment.

[iv] Shifting Tax Responsibility to Partners. Under IRC Section 6226 the partnership may shift the burden of the tax adjustments back to the persons who were partners of the partnership during the reviewed year. However, IRC Section 6226(a)(1) requires the partnership to elect this treatment not later than 45 days after the date of the notice of final partnership adjustment. This election will preclude the partnership of the partners from judicial review of the partnership adjustment.

[v] Election Out for "Small" Partnerships. IRC Section 6221(b) allows certain partnerships to elect out of the foregoing Subchapter C treatment. If a partnership elects out, the partners will be subject to the pre-TEFRA partnership audit rules requiring the IRS to deal separately with the partnership and each partner. To use this election the partnership must satisfy certain requirements and must elect application of IRC Section 6221(b) for the tax year.

To make the election, the partnership must be required to furnish not more than 100 K-1s with respect to its partners for such tax year and each partner of the partnership for such tax year must be an individual, a corporation, any foreign entity that would be treated as a C corporation if it were domestic, an S corporation, or an estate of a deceased partner.[266] Thus, unless permitted by regulations or other guidance, a partnership having a partnership or a trust as a partner will not be allowed to elect out. The election is made with a timely-filed return for such tax year and must include a disclosure of the name and TIN of each partner of the partnership and the partnership must notify each partner of the election out.

For purposes of applying the election-out test, special rules apply to each S corporation partner.[267] First, the partnership must include a disclosure of the name and TIN of each person to whom the S corporation is required to furnish an S corporation K-1 for the tax year of the S corporation ending with or within the partnership tax year for which the election out is made. Second, in applying the 100 or less statements test, each such statement to an S corporation shareholder is treated as a statement furnished by the partnership.

The Service is given authority to prescribe rules similar to the S corporation rules with respect to partners not described in the specific S corporation provision or in IRC Section 6221(b)(1)(C). Thus, absent regulations or other guidance, a partnership having a trust[268] as a partner may not elect out, but a

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[265] IRC § 6225(c)(4)(A).

[266] IRC § 6225(b)(1)(C).

[267] IRC § 6225(b)(2)(A).

[268] It is not clear how a grantor trust, particularly a grantor trust that supplies its own TIN, will be treated for purposes of this election-out requirement.

partnership having an S corporation partner with a trust as an S corporation shareholder may be able to elect out.

[vi] Procedures for Tax Assessment and Collection. IRC Sections 6231 through 6235 address the procedures for determination of a partnership readjustment, assessment and collection of an imputed underpayment, interest and penalties, and period of limitations on making adjustments.

IRC Section 6231 provides for three steps in the process:

1) Notice of an administrative proceeding initiated at the partnership level.

2) Notice of any proposed partnership adjustment resulting from such proceeding.

Notice of any final partnership adjustment resulting from such proceeding.

Any notice of final partnership adjustment cannot be mailed earlier than 270 days after the date on which the notice of proposed partnership adjustment was mailed.

Under IRC Section 6232, generally no assessment of a deficiency may be made (and no collection action related to such adjustments commenced), before the close of the 90th day after the date on which the notice of final partnership adjustment was mailed, or if a petition is filed for judicial review of the adjustment, before the decision of the court has become final.

Under IRC Section 6234, the partnership may seek judicial review of the adjustments in a notice of final partnership adjustments by filing a petition for readjustment within the 90-day period with the Tax Court, the district court for the district in which the partnership's principal place of business is located, or the Claims Court. However, to bring the action in a district court or the Claims Court, the partnership must deposit with the Service, on or before the date the petition is filed, the amount of the imputed underpayment (as of the date of the filing of the petition) determined as if the partnership adjustment was made as provided in the notice of final partnership adjustment.[269]

Interest and penalties related to a partnership adjustment are covered under IRC Section 6233.

[vii] Limitations Period. IRC Section 6235 provides for periods of limitations on making adjustments. The general limitations period is the date that is three years after the latest of: (1) the date the partnership return is filed; (2) the partnership return due date for such year (determined without regard to extensions); or (3) the date on which the partnership filed an administrative adjustment request with respect to such year under IRC Section 6227. The period of limitations is extended to six years in the case of a substantial omission from gross income, and no period of limitation applies in cases of a fraudulent partnership return or where the partnership fails to file a return for any tax year.

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[269] IRC § 6234(b).

1.08 ENTITY OF CHOICE AND ENTITY STRUCTURES FOR SPECIFIC APPLICATIONS.

[1] The Operating Business.

For most operating businesses where special allocations of income or loss will not be needed, an S corporation would appear to be the entity of choice because it is only subject to one level of taxation (unlike C corporations) and because of the ability to distribute earnings not attributable to services performed by the shareholder-employees as dividends not subject to the self-employment tax (unlike partnerships and LLCs).

[2] The Professional Practice.

Because of the recent developments discussed above subjecting the earnings of professional practices operating as C corporations to double taxation both under the independent investor test and under the compensatory intent test, and because the sale of assets of a professional practice operating as a C corporation will be subject to double taxation and there can be no assurance of avoidance of double taxation through allocation of a large portion of the sales proceeds to personal goodwill, as well as the ability to make distributions without being subject to the self-employment tax (unlike partnerships and LLCs), the choice of entity for the professional corporation would appear to be an S corporation, with the partnership (LLC) being a close second.

[3] Structuring Private Equity Fund Investments.

[a] General. Private equity, as referred to in this section, includes venture capital investments in entrepreneurial start-ups, investments in and the financing of growth businesses, leveraged buyouts, management buyouts, and recapitalizations of existing businesses and companies in financial trouble.

Private equity investors and private equity funds actively acquire portfolio investments through the buyout of operating companies from the founder shareholders, as well as from purchases of businesses from diversified companies operating many businesses and subsidiaries and divisions, wishing to divest a non-core business or a business that it is unable to make profitable. These middle market businesses may have been historically operated as C corporations, S corporations, or limited liability companies.

The private equity investor hopes that additional capital for expansion, synergy through additional acquisitions, properly incentivized management, and close supervision by sophisticated management, or a combination of these circumstances, will cause the enterprise value of the portfolio company's business and operations to increase geometrically.

Private equity investors are generally willing to expose capital to risk in order to achieve higher rates of return. There are cheaper sources of capital than private equity capital, such as traditional bank loans and private placements of senior debt securities. However, such sources may not be available to an early stage entrepreneur with no proven business plan or collateral or an operating company producing cash flow deficits. Even if traditional financing is available for a portion of the capital required, private equity financing may be necessary to provide the equity base for a business plan to succeed.

Federal law has encouraged private equity investments through various tax and other incentives for over 50 years. The Small Business Investment Act of 1958 permitted banks and bank holding companies to invest in Small Business Investment Corporations (SBICs) subject to certain restrictions.[270] The involvement of banks in private equity investments through the 1960s and 1970s provided the basis for the development of a professional private equity industry in the United States.

Today, participants in private equity transactions include high net worth individuals, merchant banking subsidiaries or divisions of bank holding companies, insurance companies, investment banks, and other large corporations, publicly held and privately held funds formed for the purpose of making private equity investments, and employee pension plans, university endowment funds, and other investors looking for a greater than normal investment return which generally require a high level of risk. Special private equity funds have been formed to permit private investors to diversify their risk among a portfolio of investments, while achieving professional management and oversight of the investments.

An operating company may be reasonably successful, but it may require equity capital from nontraditional private equity sources if traditional financing is not available from bank lenders, or the bank lenders condition credit on the infusion of additional equity capital. The founders may not be ready to sell out to a third party, as they may still have confidence in the original business plan and their ability to execute it. However, without additional private equity, the company may not realize its true potential.

[b] Structuring Private Equity Investments in an Operating Company. Private equity investors often find profit opportunities in "growth-equity" investments in existing operating companies. The investment capital may be used to fuel expansion, to provide an equity base to support cost effective borrowing from traditional bank lenders, to purchase the stock formerly held by senior founders or their estates, or to recapitalize the current equity and debt structure of the company to provide the foundation for future growth and expansion. The best use of the capital raised from mezzanine and private equity investors is the direct funding of growth and expansion initiatives or strategic acquisitions. In the alternative, mezzanine debt and equity and private equity capital may be raised to buyout original shareholders who no longer contribute to the business plan, or in the case of deceased shareholder, where money is needed to pay estate taxes.

[i] Capital Structure of Operating Company. If a cheaper source of capital were available to the operating company, such as bank financing, asset based lending, or equipment leasing, the founders would take advantage of such sources. However, such sources may have "maxed out" and the founders may be required to seek either (a) subordinated debt, in

[270] An SBIC may invest in a business or "portfolio company" if it meets one of two "size standards" (i) the portfolio company has tangible book net work (exclusive of intangible assets such as "goodwill") that do not exceed $18 million and the prior two fiscal years' average net income does not exceed $6 million, or (ii) the portfolio copay meets certain employee or revenue standards published by the SBA for the industry in which it is principally engaged. While an SBIC may continue to invest in a portfolio company after it exceeds the size standards, it must divest itself of control after 7 years (subject to extension with the SBA's approval to complete divestiture of control or to ensure the company's financial stability).

the form of debt mezzanine capital, or (b) equity, in the form of equity mezzanine capital or pure private equity, from private equity investors.

Debt mezzanine capital may be structured to provide the mezzanine lender with a preferred position through the issuance of subordinated debt, behind senior lenders but ahead of the founders' equity. In addition, equity may be provided through the issuance of preferred stock by a C corporation (multiple classes of stock are not permitted for an S corporation), preferred LLC or partnership interests, or through the issuance of warrants and convertible debt, discussed further below.

A concern of the mezzanine or private equity investor that must be addressed in the capital structure is maintaining a position that is senior to the equity holders, although junior to the senior lenders, putting them "second in line" to realize any value left in the event of the liquidation of the business. Generally, the private equity investment may be structured through a tax free recapitalization of the operating company. Since the private equity investor does not have control of the company, as in the case of a buy-out, the potential for a successful investment will continue to depend on the business acumen and ability of the existing founders or management group to execute the business plan. The private equity investors will seek to ensure that the management group IS properly incentivized to ensure the success of the portfolio company.

There are several ways to recapitalize an existing company to accommodate private equity investments, usually ensuring that the private equity investor has some liquidation preference over the founders. A recapitalization may be accomplished by the transfer of shares in the operating company to a holding company, qualifying as a tax free Section 351 transaction, or the tax free recapitalization of the operating company under Section 368(a)(1)(E) (an "E recap").

In either a Section 351 transaction or an E recap, there is risk that preferred stock, issued on a non pro rata basis to the passive shareholders in exchange for a substantial block of common stock, will subject the preferred stock to Section "306 stock" treatment. Since the proceeds of the disposition of Section 306 stock is subject to the tax rate of 20% applicable to "qualified dividends," without reduction for basis, or subject to the dividends received exclusion for a corporate taxpayer, the consequences of the Section 306 taint may not be particularly objectionable.

[ii] <u>Avoiding Nonqualified Preferred Stock Treatment for Portfolio Companies Operated as C Corporations</u>. The 1997 Tax Act imposed additional barriers to achieving favorable tax consequences through the use of preferred stock in the capital structure of a C corporation, by defining a new category of preferred stock called "nonqualified preferred stock." Nonqualified preferred stock is preferred stock that meets any one of four tests:

(1) The holder has the right to require the issuer (or a related person) to redeem or purchase the stock within 20 years after the issuance date.

(2) The issuer (or a related person) is required to redeem or purchase the stock within 20 years after the issuance date.

(3) The issuer (or a related person) has the right to redeem or purchase the stock, and as of the issuance date, it is more likely than not that the right will be exercised within 20 years after the issuance date.

(4) The dividend rate on the stock varies in whole or in part with reference to an indexed interest rate, commodity price, or other similar indices, regardless of whether varying the rate is an express term of the stock, or results from other aspects of the stock.

Even if stock qualifies under one of the foregoing tests, it is treated as nonqualified preferred stock only if it is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." A shareholder who receives nonqualified preferred stock in an otherwise tax free recapitalization is required to recognize gain (generally long-term capital gain) even where the redemption would have been "essentially equivalent to a dividend" under Section 302 or otherwise subject to treatment as a dividend under Section 301 and eligible for the 20% tax rate for qualified dividends, or the dividend received exclusion in the case of a corporate recipient.

Nonqualified preferred stock is, by definition, not tainted by Section 306 since nonqualified preferred stock is not received by the passive shareholder tax free. A subsequent sale or redemption of the nonqualified preferred stock would not produce Section 306 dividend income to the passive shareholders, although a redemption of nonqualified preferred stock might result in dividend income under Section 302.

[iii] Preferred Interest in Portfolio Company Operated as Partnership or LLC. While a preferred interest in an S corporation cannot be obtained by a private equity investor as a result of a single class of stock rules, the investment may be structured to avoid the double tax by issuing the private equity investor a preferred interest in a limited liability company, which may be the historic operating company, or a newly formed LLC or partnership with an S corporation as a member or partner.

While a preferred membership interest in an LLC is not secured and would be lower on the pecking order than subordinated debt, a preferred interest may be one component of the capitalization structure to ensure the private equity investor that it will "get its money back" with some level of return commensurate with its minimum expectations, while at the same time being ahead of the founder equity investors. Preferred returns and special allocation provisions, common to private equity and venture capital investment transactions, may be drafted into the partnership agreement or the LLC operating agreement.[271]

[iv] Unrelated Business Taxable Income for Tax-Exempt Entities. If a portfolio company is organized as a pass-through entity, income tax is avoided at the entity level and passed-through to the private equity investors. Taxable investors pay federal income taxes at the marginal rate applicable after considering all other items of income, loss, deduction, and credit.

Tax-exempt entities, including employee pension plans, are exempt from federal income tax on many items of income. Section 511 imposes tax on the "unrelated business taxable

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[271] Section 704(a) provides that a partnership's share of income, gain, loss, deduction or credit shall, unless otherwise provided, be determined by the partnership agreement. Under Section 704(b), the Service will respect allocations of partnership income or loss provided (i) the allocations have "substantial economic effect," as further defined in the Regulations, or (ii) taking into account all facts and circumstances, the allocations are in accordance with the "partner's interest in the partnership."

income" or "UBTI" of a tax-exempt entity at regular graduated rates, computed under the same rules applied to domestic corporations.[272] This would include the tax-exempt partner's share of the UBTI of a partnership or limited liability company.

In addition, Section 514 may cause otherwise exempt interest, dividends or capital gains to be taxed as UBTI if the underlying investment is "debt financed" either as a result of borrowing by the tax-exempt entity, or borrowing by a partnership of which the tax-exempt entity is a partner.[273] While private equity funds seldom borrow or incur acquisition debt, as in the case of a hedge fund, acquisition debt commonly is incurred by a portfolio company. If the portfolio company is a pass-through entity, the debt may "taint" all or portion of any gain on the sale allocable to the tax-exempt investors.

[v] Effectively Connected Income for Foreign Investors. Foreign persons are subject to federal income tax on income effectively connected with the conduct of a U.S. trade or business ("ECI"). If a treaty applies[274] the IRS must establish that the income in question is "attributable to" a U.S. permanent establishment of the foreign person, in which event the income is subject to tax at the maximum rate of 35%. Absent treaty protection, foreign corporations are subject to the "branch profits tax" on the repatriation of ECI from the United States to the foreign jurisdiction, at a rate of 30%. In effect, foreign corporations are subject to federal tax on ECI at a rate of 54.5%, without regard to state and local taxes.[275]

Like tax-exempt organizations, which are subject to UBTI on business activities of a partnership, foreign persons are subject to tax on ECI attributable to a partnership engaged in U.S. trade or business and allocable to the foreign person. A foreign person or a partnership in which the foreign person is a partner is subject to tax on ECI upon the sale of an interest in a partnership engaged in a U.S. trade or business.[276] The ECI tax regime is backstopped by the requirement that a partnership that generates ECI must withhold the foreign partner's "applicable percentage" determined under Section 704.[277]

[vi] Use of "Blocker" Entities to Avoid UBTI/ECI. Tax-exempt and foreign investors, and funds in which tax-exempt and foreign investors invest, often interpose a corporate "blocker" entity between the investors and the portfolio investment to "trap" the operating profits of the portfolio company within a separate taxable entity. The blocker structure prevents the trade or business activities of the entity from passing through the tiers to the tax-exempt or foreign shareholders. While not resulting in any significant tax savings, the use of a blocker entity avoids the need to report the UBTI and ECI at the investor level.[278] The tax-exempt or foreign investor may avoid the need to file a U.S. tax return otherwise triggered by the EBTI or ECI from a portfolio company investment shielded by the blocker.

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[272] Section 511(a)(i).
[273] Reg. §1.514(c-1)(a), example 4.
[274] U.S. Model Income Tax Convention of September 20, 1996, Article 5.
[275] Section 11 and Section 884 (35% plus (1 - 35%) x 30% = 54.5%).
[276] See Rev. Rul. 91-32, 1991-1 C.B.107.
[277] Section 1446(a).
[278] The indirect tax burden incurred by the investors at the blocker level will roughly approximate the tax that the tax-exempt or foreign investor would have paid on the UBTI or ECI.

Unlike hedge funds, which often structure investments by tax-exempt and foreign investors through offshore entities, private equity funds must deal with the fact that income generated by U.S. based portfolio companies is subject to tax as U.S. source income.

Blocker entities may reside in parallel fund structures, in which the fund invests all capital earmarked for pass-through entities and invested by foreign and tax-exempt investors through a blocker entity, and all other funds directly in the portfolio company. This prevents the other investors (not tax-exempt and foreign investors) from being subject to an additional level of tax at the blocker level. If the fund (or a direct investment in a portfolio company by a foreign or tax-exempt investor) does not involve a blocker in its structure, the tax-exempt or foreign investor may choose to interpose a blocker between the investor and the fund or portfolio investment as a "feeder" organization. If the tax-exempt or foreign investor forms its own blocker, it may domicile the entity in a tax haven jurisdiction to avoid U.S. taxes on income that is not ECI and to avoid U.S. withholding taxes from distributions to the investor by the blocker. The use of a blocker domiciled in a tax haven jurisdiction will permit a tax-exempt investor from being subject to tax on UBTI sourced in a foreign jurisdiction.

The transfer of investments or the structuring of investments to utilize blocker entities by tax-exempt and foreign investors should be respected for federal tax purposes. A corporation should be recognized as a corporation for tax purposes if it is either formed for a substantial business purpose or engaged in substantial business activity.[279] Even if an explicit shareholder purpose is to avoid taxes by the use of the blocker, the blocker corporation should be perceived as carrying out substantive business functions and therefore the corporation should not be ignored as a viable business entity. Similarly, the IRS should not be able to assert that the shareholders formed or acquired control of the blocker for "tax avoidance" purposes under Section 269 of the Code. In a parallel fund structure, shareholder use of the blocker may be sufficiently dispersed to avoid the "control" test of Section 269. In addition, the blocker structure may achieve only marginal tax savings for the shareholders, serving primarily to downstream the tax return filing requirements or to facilitate the later sale of stock in the blocker entity. As a separate corporation, the blocker will always bear full corporate tax on its ECI, and in the case of a domestically formed blocker, on its worldwide income.

[vii] Limitations on the Use of Debt to Minimize Corporate Tax ("Earnings Stripping"). The use of senior and subordinated acquisition debt on favorable terms may provide the private equity investor with the opportunity to generate tax deductions at the entity level and increase the overall return on capital deployed in a portfolio company acquisition. The senior financing may be provided by a traditional lender. Subordinated debt financing may be used by the private equity investor to create interest deductions and "strip" corporate earnings from a C corporation. Earnings stripping is subject to numerous limitations, including: (i) the proposed debt/equity regulations under Section 385 (discussed further below), (ii) the original interest discount ("OID") rules requiring the amortization of the debt holder's interest income over the life of a debt obligation on a constant yield to maturity basis,[280] (iii) the Section 279 limitations on interest on convertible and nonconvertible debentures accompanied by warrants to acquire equity, (iv) the Section 163(e)(5) limitations applicable high yield

[279] Moline Properties v Commissioner, 319 U.S. 436 (1943).
[280] Sections 1272 and 1273.

discount obligations ("AHYDO") involving debt instruments issued by C corporations with a maturity of more than 5 years after issuance and OID and payment in kind ("PIK") features with a yield equal or in excess of 5 percentage points over the applicable federal rate ("AFR"), (v) the Section 163(j) limitations on interest payable to or guaranteed by a related lender, and (vi) the Section 163(l) limitation on equity linked debt where there is a substantial certainty that an option to convert the debt into equity will be exercised.

Each of these limitations and the proposed Section 385 Regulations must be carefully navigated where debt is used in the capital structure of a private equity investment through a C corporation, regardless of whether the use of debt is tax motivated.

On April 4, 2016, Treasury and the Service released proposed regulations under Section 385.[281] If finalized in their current form, the Proposed Regulations would make sweeping changes to the characterization of instruments issued by a corporation to a related party that were previously treated as indebtedness under current law.

The Proposed Regulations consist of three sets of rules. First, the Bifurcation Rule provides that the Service may treat certain instruments that are in the form of debt as in part indebtedness and in part stock to the extent they are properly treated as such under general debt/equity testing principles.[282] In particular, the Bifurcation Rule can potentially apply to any expanded group instrument ("EGI"), as modified by Proposed Regulation Section 1.385-1(d)(1). The term "expanded group" generally refers to an affiliated group as defined in Section 1504(a), with certain modifications to expand its scope, including by counting indirect stock ownership under the rules of Section 304(c)(3). The term "modified expanded group" is defined in the same manner as the expanded group, but adopting a 50% ownership threshold, and adding further potential noncorporate members. An EGI is an instrument that is in form a debt instrument issued by a member of an expanded group and held by a member of the same expanded group.[283] Proposed Regulation Section 1.385-1(d)(2) modifies the definition of EGI to apply to instruments issued and held by members of a modified expanded group.[284]

Second, the Documentation Rule provides that an EGI is treated as stock for U.S. federal income tax purposes if certain documentation and information requirements are not satisfied.[285]

Third, the Proposed Regulations provide a regime whereby certain instruments that would otherwise be treated as indebtedness for U.S. federal income tax purposes are instead treated as stock of the issuer to the extent such instruments are issued in certain specified transactions or issued with a principal purpose of funding, or are treated by the Proposed Regulations as being issued with a principal purpose of funding, such specified transactions.[286]

[4] Real Estate Investments.

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[281] *See* Notice of Proposed Rulemaking, 81 Fed. Reg. 20,914.

[282] *See generally* Prop. Reg. § 1.385-1(d), 81 Fed. Reg. 20,912, 20,931 (2016).

[283] Prop. Reg. §§ 1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

[284] Prop. Reg. §§ 1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

[285] *See generally* Prop. Reg. § 1.385-2, 81 Fed. Reg. at 20,931.

[286] *See generally* Prop. Reg. § 1.385-3, 81 Fed. Reg. at 20,934.

[a] Advantages of Partnerships and Limited Liability Companies. Limited partnerships, and LLCs taxed as partnerships and disregarded entities, are ideally suited for holding real property for a number of reasons.

[i] *Limited Liability for Investors*. Most real estate investors want to avoid potential personal liability as a result of their ownership of real estate while at the same time having some control over the development, operation and disposition of the real estate. Prior to the advent of LLCs, limited partnerships were commonly used. In structures involved the developer, who often contributes little money as the general partner while the limited partners contribute capital to the partnership as limited partners. The developer would often set up a separate corporation, perhaps electing S corporation treatment, to serve as the general partner in order to try to limit the general partner's personal liability. The limited partners could have only limited say in the management of the business if they wanted to avoid personal liability for the obligations of the partnership. Limited partnerships and even general partnerships are often used to hold real estate used in special situations.

[ii] *Avoiding Cumbersome Structures*. The LLC avoids cumbersome structures required in the case of limited partnerships with corporate general partners. The developer can individually be a member and manager of the LLC without subjecting himself to personal liability and therefore can avoid the extra administrative costs and hassles of setting up a corporation to serve as general partner in order to avoid personal liability. In addition, the investor members can have much more control over their investments without risking personal liability (except, of course, to the extent a lender may require personal guarantees).

[iii] *Avoiding Double Taxation*. Many real estate investors do not want to hold real property in a regular C corporation in order to avoid a possible double tax on the appreciation of the real estate when the real estate is ultimately sold or distributed to the owners. This "double taxation" (taxation at both the corporate and shareholder levels) of the appreciation in real estate is a significant disadvantage to the holding of real estate by a C corporation.

[iv] *Pass-through Losses of Real Estate*. If the real estate investment is generating losses through depreciation, interest or other deductions and is held by a C corporation rather than a pass-through entity such as an LLC (that has elected to be taxed as a partnership), a partnership or an S corporation, the losses will not be available to offset other income of the C corporation shareholder. However, the basis, at-risk and passive loss rules may also restrict the LLC member from using the LLC losses to offset other income of the member.

[v] *Avoiding Limitations on Type and Number of Owners; Special Allocations; Basis for Entity Level Debt*. While an S corporation avoids the double taxation issue, it has other disadvantages for holding real estate when compared to an LLC. S corporations have restrictions on the type and number of shareholders. In addition, S corporations may not have a second class of stock, which may be deemed to be the case if preferred returns or special allocations are utilized in structuring the real estate investment. Also, an S corporation shareholder is not allowed to add the shareholder's proportionate share of the corporation's debt to the shareholder's stock basis, which may result in losses not being utilized, while the opposite is often true for a partner or a member of an LLC. This ability to use the debt of the entity to increase the owner's basis in his investment and therefore utilize his proportionate share of loss from the entity is often very important to real estate investors.

[vi] *Like kind Exchanges.* Taxpayers can structure like kind exchanges with disregarded entities as special purpose holding companies using single member LLCs.

[b] Private REIT Structures. While limited partnerships and LLCs are generally the preferred vehicles for private investment in real estate, private REITs may provide significantly better tax results in certain circumstances

[i] REIT Organizational Requirements. A REIT is a "real estate investment trust" governed by Sections 656 through 659 of the Code. REITs must meet certain requirements relating to organization, sources of income, nature of assets, distributions of income to stockholders and recordkeeping. While many REITs are publicly held, strictures involving "private REITs" are quite common. In order to qualify, and continue to qualify for taxation as a REIT under the Code, an entity must:

- be a taxable domestic corporation but for Sections 856 through 859 of the Code;
- be managed by one or more trustees or directors;
- have transferable shares;
- not be a financial institution or an insurance company;
- have at least 100 stockholders for at least 335 days of each taxable year of 12 months;
- not be closely held (the "5 or fewer test, discussed further below);
- elect to be a REIT, or make such election for a previous taxable year, and satisfy all relevant filing and other administrative requirements established by the IRS that must be met to elect and maintain REIT status;
- use a calendar year for federal income tax purposes and comply with the recordkeeping requirements of the federal tax laws;
- distribute all earnings and profits attributable to a taxable year in which we do not qualify as a REIT by the end of our first year as a REIT; and
- meet certain other tests, described below, regarding the nature of our income and assets.

Private REITs deal with the 100 shareholder requirement in several ways. One approach is to find 99 friends and family members, as there is no attribution limitation. Another approach is to issue non-voting preferred shares to between 115 and 125 investors. Shares are typically priced at U.S. $1,000, are subject to redemption at par plus accrued but unpaid dividends, and pay a fixed dividend. A limited number of these preferred shares are sold, and often no more than $125,000 is invested in these shares in the aggregate. A "rent your REIT shareholders" industry has emerged to facilitate the investment by preferred holders and manage investor relations. The convenience of a specialized company can be helpful because it has the procedures in place to track the investors as they change over time.

The non-closely held requirement is also a concern for private REITs. A REIT will lose its favorable U.S. tax classification if 5 or fewer individuals collectively own more than 50%, by value, of the REIT's shares. Ownership is tested by looking up through the chain of direct and

indirect ownership, with shares owned by entities generally treated as if owned proportionately by their equity holders. As a result of these look-through rules, it is necessary to restrict transfers of both directly and indirectly held REIT shares. Because the consequences of loss of REIT status are so dire – the corporation becomes fully taxable on its income and sales of its shares are fully taxable to international shareholders - these restrictions are generally enforced by bylaw and charter restrictions. Thus, it is common for REIT organizational documents to limit the ownership of any one shareholder to 9.9% of the equity interests in the REIT. Therefore, no group of five shareholders can own more than 50% of the equity interests in the REIT.

In the case of a REIT that is a partner in a partnership, the Regulations provide that the REIT is deemed to own its proportionate share, based on its interest in partnership capital, of the assets of the partnership and is deemed to have earned its allocable share of partnership income. Also, if a REIT owns a qualified REIT subsidiary, which is defined as a corporation wholly-owned by a REIT that does not elect to be taxed as a taxable REIT subsidiary under the Code, or owns all of the interests in an unincorporated domestic entity, such as a limited liability company, which is generally treated as a disregarded entity for federal income tax purposes, the REIT will be deemed to own all of the qualified REIT subsidiary's or other disregarded entity's assets and liabilities and it will be deemed to be entitled to treat the income of that entity as its own. In addition, the character of the assets and gross income of the partnership, qualified REIT subsidiary or other disregarded entity shall retain the same character in the hands of the REIT for purposes of satisfying the gross income tests and asset tests set forth in the Code.

[ii] Income Tests for REIT Status. To qualify and maintain our qualification as a REIT, an entity must on annual basis satisfy the following gross income requirements:

- At least 75% of gross income, including dividends from a subsidiary REIT, but excluding gross income from prohibited transactions and dividends from any corporate subsidiaries including any REIT subsidiary that fails to qualify as a REIT, for each taxable year must be derived directly or indirectly from investments relating to real property or mortgages on real property or qualified temporary investment income. Qualifying income for purposes of that 75% gross income test generally includes:
  - rents from real property;
  - interest on debt secured by mortgages on real property or on interests in real property;
  - dividends or other distributions on, and gain from the sale of, shares in other REITs;
  - gain from the sale of real estate assets;
  - income derived from the temporary investment of new capital that is attributable to the issuance of our shares of common stock or a public offering of our debt with a maturity date of at least five years and that we receive during the one-year period beginning on the date on which we received such capital;
  - gross income from foreclosure property; and

- income derived from the temporary investment of new capital that is attributable to the issuance of our stock or a public offering of our debt with a maturity date of at least five years and that we receive during the one-year period beginning on the date on which we received such new capital.

This is known as the 75% Income Test. Gross income from dispositions of real property held primarily for sale in the ordinary course of business is excluded from the 75% Income Test. Such dispositions are referred to as "prohibited transactions."

In general, at least 95% of gross income for each taxable year must consist of income that is qualifying income for purposes of the 75% gross income test, other types of interest and dividends or gain from the sale or disposition of stock or securities. This is known as the 95% Income Test. Income and gain from "hedging transactions" that we enter into to hedge indebtedness incurred or to be incurred to carry our real estate assets and that are clearly and timely identified as such also will be excluded from both the numerator and the denominator for purposes of the 95% Income Test and the 75% gross income test.

Rents qualify as "rents from real property" for purposes of satisfying the gross income requirements for a REIT only if the following conditions are met:

- First, the amount of rent received from a tenant generally must not be based in whole or in part on the income or profits of any person; however, an amount received or accrued generally will not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of gross receipts or sales if such amount is in conformity with normal business practice and not used as a means to base rent on income or profits;

- Second, rents received from a tenant will not qualify as "rents from real property" if we or a direct or indirect owner of 10% or more of the REIT directly or constructively owns 10% or more of the tenant except that rents received from a taxable REIT subsidiary under certain circumstances qualify as rents from real property even if the REIT owns more than a 10% interest in the subsidiary;

- Third, if rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as "rents from real property;" and

- Fourth, we must not operate or manage the property or furnish or render services to tenants, other than through an "independent contractor" who is adequately compensated and from whom we do not derive any income. However, we may provide services with respect to our properties, and the income derived therefrom will qualify as "rents from real property," if the services are "usually or customarily rendered" in connection with the rental of space only and are not otherwise considered "rendered to the occupant." Even if the services with respect to a property are impermissible tenant services, the income derived therefrom will qualify as "rents from real property" if such income does not exceed 1% of all amounts received or accrued with respect to that property. Services generally are deemed not to be provided by us if they are provided through (i) an "independent contractor" who is adequately compensated and from whom we do not derive revenue or (ii) a taxable REIT subsidiary.

A "taxable REIT subsidiary" is a subsidiary of a REIT that makes a joint election with the REIT to be treated as a taxable REIT subsidiary. The separate existence of a taxable REIT subsidiary or other taxable corporation, unlike a "qualified REIT subsidiary" or other disregarded entity, is not ignored for U.S. federal income tax purposes. Accordingly, a taxable REIT subsidiary is generally subject to corporate income tax on its earnings, which may reduce the cash flow generated by such entity. Because a parent REIT does not include the assets and income of a taxable REIT subsidiary in determining the parent's compliance with the REIT qualification requirements, a taxable REIT subsidiary may be used by the parent REIT to undertake activities indirectly that the REIT might otherwise be precluded from undertaking directly or through pass-through subsidiaries. Certain restrictions imposed on taxable REIT subsidiaries are intended to ensure that such entities and their parent REITs will be subject to appropriate levels of U.S. federal income taxation.

A REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee in possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor under certain specific safe harbors.

[iii] Asset Tests for REIT Status. At the close of each quarter of the taxable year in which an entity is taxed as a REIT, the entity must satisfy the following tests relating to the nature and diversification of its assets:

- First, at least 75% of the value of the total assets must be represented by real estate assets, cash, cash items, and government securities. The term "real estate assets" includes real property, mortgages on real property, shares in other qualified REITs and a proportionate share of any real estate assets owned by a partnership in which we are a partner or of any qualified REIT subsidiary of ours.

- Second, no more than 25% of total assets may be represented by securities other than those in the 75% asset class.

- Third, of the investments included in the 25% asset class (other than stock of a taxable REIT subsidiary), the value of any one issuer's securities may not exceed 5% of the value of total assets. Additionally, the entity may not own more than 10% of any one issuer's outstanding securities (based on either voting rights or value), except in the case of our taxable REIT subsidiaries.

- Finally, the value of all of the securities of our taxable REIT subsidiaries may not exceed 25% of the value of our total assets. Under The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act" or the "Act"), effective for tax years beginning after December 31, 2017, the securities of one or more TRSs held by a REIT may not represent more than 20% (rather than 25% under current law) of the value of the REIT's assets.

For purposes of the 5% and 10% asset tests, the term "securities" generally includes debt securities issued by a partnership or another REIT, except that for purposes of the 10% value test, the term "securities" does not include "straight debt," as defined by the regulations.

[iv] REIT Distribution Requirements. In order to be taxed as a REIT, an entity is required to make distributions, other than capital gain distributions, to stockholders each year in the amount of at least 90% of REIT taxable income, which is computed without regard to the dividends paid deduction and our net capital gain, and is subject to certain other

potential adjustments. Distributions with respect to a taxable year to which they relate may be paid in the following taxable year if they are (1) declared before the timely filing of a U.S. federal income tax return for the taxable year in question, and if (2) made on or before the first regular distribution payment date after the declaration.

If an entity satisfies the foregoing distribution requirements and, accordingly, continue to qualify as a REIT for tax purposes, the entity will still be subject to tax on the excess of its net capital gain and our REIT taxable income, as adjusted, over the amount of distributions made to stockholders.

If a REIT elects to retain, rather than distribute, its net long-term capital gains, the REIT would be required to pay the tax on these gains, the stockholders, while required to include their proportionate share of the undistributed long-term capital gains in income, would receive a credit or refund for their share of the tax paid; and the basis of a stockholder's shares would be increased by the difference between the designated amount included in the stockholder's long-term capital gains and the tax deemed paid with respect to such shares.

[v] REITs Structured as Joint Ventures. In many cases, additional flexibility may be obtained by forming a joint venture in the form of a partnership or LLC to own all of the common shares of the REIT. A joint venture entity allows easier navigation of the various REIT qualification rules and the investors' economic and control objectives.

Free Transferability. The joint venture can limit the transferability of its common shares so that the parties can control who their partners are. REITs cannot achieve this directly, because their shares are required to be freely transferable.

Complex Waterfalls, Including Preferred Returns. While distribution waterfalls can be affected through multiple classes of stock in a corporate structure, a more tax efficient distribution waterfall can be drafted using a joint venture taxed as a partnership. This is particularly the case where priority preferred returns and catch-ups are desired or where there are "clawback" provisions.

Preferential Dividends. REITs are prohibited from paying preferential dividends, which include dividends at different rates on the same class of shares. Where the REIT is owned by a joint venture, different dividend rates and fee loads can be accomplished at the joint venture level without risking disqualification of the REIT.

Management. Joint ventures are more flexible and can bind the entity more effectively than similar provisions in a corporate context. REITs require "centralized" management. In the typical joint venture, there is an "operating" partner or manager and a number of "major decisions" that require the approval of the larger investors. Those investors may insist on the right to force a sale or refinancing and often will also require their consent be obtained for any sale or refinancing proposed by the operator. While these limitations can be accomplished in a centralized management environment, the mechanisms to accomplish this are often cumbersome and formalistic. Addressing the resolution of an impasse and other similar joint venture management issues is also much more difficult in practice, if achievable at all, if the investors invest directly in the REIT rather than through a joint venture.

[vi] Tax Advantages of REIT Structures for Foreign Investors in U. S. Real Estate. An international investor who owns U.S. real estate (directly or through a flow-through or "fiscally transparent" entity for U.S. tax purposes) generally is required to file state

income tax returns in each state in which the U.S. real estate is located, in addition to a federal income tax return. To avoid these U.S. tax filing obligations, international investors often make their investment in U.S. real estate through a U.S. corporation, typically referred to as a "blocker," because it blocks these filing obligations and imposes them on the U.S. corporation instead. A REIT is a corporation for this purpose and as such generally serves to minimize U.S. tax filing obligations.

As a practical matter, REITs generally distribute all of their taxable earnings to avoid corporate-level income taxes on any undistributed taxable earnings. Generally, a U.S. corporation that is not a REIT is taxable on all of its income, whether from operations or capital transactions, with a top federal rate of 35% plus state and local taxes that vary significantly, depending on the state (and sometimes the city) where the corporation's property is located. REITs, however, are subject to a special tax regime under which distributions to shareholders are deductible in computing taxable income, effectively eliminating corporate taxes at the REIT level. To qualify as a REIT, the REIT must distribute at least 90% of its taxable non-capital gain income to its shareholders each year and, further, any undistributed earnings, whether ordinary or capital, are subject to corporate tax. The net result is that REITs distribute all or nearly all of their operating income and gains each year to their shareholders. Distributions by REITs to their shareholders are characterized as dividends under U.S. law and most treaties. Most dividends paid to foreign shareholders are subject to U.S. tax at a flat 30% rate. Although that rate may be (and often is) reduced by treaty, REIT dividends may be subject to a less favorable withholding rate than regular dividends. A "consent dividend" provides an opportunity for the REIT to be treated as making a dividend for tax purposes without the need to actually distribute cash.[287]

Capital gains and certain other types of income are subject to special treatment and are not included for the purpose of applying the 90% test. Capital gains are not required to be distributed, but any undistributed capital gains are subject to taxation at applicable corporate rates. As a result, it is very rare for public and private REITs not to distribute all capital gains. The rationale for this distinction is that a REIT, unlike a regular corporation, normally does not pay tax at the entity level and thus does not need a lower withholding tax rate on its dividends to mitigate double taxation.

Although most REIT dividends will be taxed at a flat 30% or lower treaty rate (if applicable), to the extent that the source of the dividend is gain from the sale of U.S. real estate, the dividend is subject to tax under FIRPTA. The amount subject to FIRPTA tax is the amount designated by the REIT as a capital gain dividend. Foreign investors receiving designated capital gain dividends are taxable on those dividends in the U.S. at graduated federal income tax rates. If the international investor is a corporation, the corporate rates apply (which is generally 35%) Specifically, the Foreign Investment in Real Property Tax Act ("FIRPTA") generally provides that income and gain from the disposition of U.S. real estate must be subjected to U.S. tax. FIRPTA treats capital gain dividends from REITs that are not domestically controlled as "effectively connected income," which is subject to tax at normal graduated U.S. rates.

If the real estate is held by a corporation (such as a REIT), these rules also taint the sale of the corporate stock if the corporation is a United States Real Property Holding Corporation ("USRPHC"). In general, a corporation is considered a USRPHC if 50% or more of the gross

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[287] *See* sections 561(a) and 565.

value of a corporation's assets in the year of sale or in any of the previous five years is attributable to U.S. real estate. Equity REITs are, by definition, USRPHCs, because investments in U.S. real estate represent far more than 50% of the gross value of their assets. As a result, the sale of the stock of a REIT by a foreign shareholder is subject to U.S. tax unless the REIT is exempt from USRPHC status. FIRPTA grants this exemption to domestically controlled REITs.[288] Where this exemption applies, a foreign shareholder is not taxed on the sale of its REIT stock. Therefore, sophisticated international investors prefer to invest through private domestically controlled REITs.

[vii] Tax Advantages of REIT Structures for Tax Exempt Investors. Tax exempt organizations, such as retirement plans, charities, and private foundations, are not subject to federal income tax on investment income, but are subject to federal income tax on "unrelated business taxable income" or UBIT, including income arising from debt finance property. Real estate investments are often debt financed A REIT is not subject to tax on UBTI, and significantly, the UBTI does not flow through to a tax exempt investor. An exception to this rule applies if pension investors hold more than 25% of the equity interests in a REIT (a "pension held REIT"), in which case the tax exempt investors are subject to the UBTI rules. This is often avoided by prohibiting tax exempt investors from owning more than a specified percentage of the equity interests of a REIT.

[viii] State Income Tax Considerations of REITs. REITs may also be used to minimize state income taxes for investments in real estate located in high tax states, where the REIT is not subject to tax on income sourced in the state, and the income is distributed to shareholders resident in low tax states.

[5] Structuring Parent Subsidiary Arrangements.

[a] Consolidated Return for Parent Subsidiary Corporations. The C corporation has historically been considered to be the proper choice if it is desirable to operate several businesses and separate corporations owned by a common parent or to operate separate subsidiaries in different states. By filing a consolidated return, the taxable income of profitable businesses may be offset by the losses of unprofitable businesses.

Section 1504 provides that an "affiliated group" eligible to file consolidated corporate tax returns consists of one or more chains of includible corporations connected through stock ownership with a common parent corporation that is an includible corporation, if: (a) the common parent owns directly stock meeting the requirements of Section 1504(a)(2) in at least one of the other includible corporations, and (b) stock meeting the requirements of Section 1504(a)(2) in each of the includible corporations, excluding the common parent, is owned directly by one or more of the other includible corporations.

Section 1504(a)(2) requires that in order for an includible corporation to be a member of an affiliated group there must be ownership of stock possessing at least 80% of the total voting power of the stock of the includible corporation (the "vote" test) and ownership of stock of the includible corporation having a value at least equal to 80% of the total value of the stock of such corporation (the "value" test), by a common parent corporation.

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[288] A domestically controlled REIT is owned 50% or more in value, directly or indirectly, by U.S. shareholders.

Associations and trusts taxable as corporations, and LLCs and partnerships electing to be taxed as corporations under the check-the-box rules are includible corporations. Similarly, corporations that are inactive or bankrupt are includible corporations. Partnerships and LLCs taxable as partnerships as well as S corporations, are not includible corporations.

An affiliated group may consist simply of a parent and a subsidiary, a parent and several first-tier subsidiaries, or any combination of multiple tiers of subsidiaries, provided that the vote and value tests are satisfied with respect to each includible corporation and the chain of stock ownership is not broken by an intervening non-includible corporation. Therefore, no corporation that is owned by a non-includible corporation can be a member of the basic affiliated group. However, an includible corporation owned by the non-includible corporation may form its own separate affiliated group if the tests of Section 1504(a) are met as to it and other directly connected includible corporations.

[b] The Single Member LLC. As noted in the discussion of disregarded entities, a single member LLC is an attractive vehicle for structuring parent-subsidiary arrangements, providing limited liability for the parent and qualifying for tax treatment similar to members of a consolidated return. Assets may be moved around without tax consequences or the complications of intra group spinoff in a consolidated group setting.

1.09 FUTURE OF BUSINESS TAXATION?

Now that we are well into the Trump administration, we have the fun of considering what the Internal Revenue Code may look like, and in the context of this presentation, how tax reform could impact S corporations and their shareholders, as well as the rest of us. The most recent guidance on what tax reform will look like is contained in the recently released "Unified Framework For Fixing Our Broken Tax Code" (the "Framework"), from the "Big Six": House Speaker Paul Ryan (R-WI), Ways and Means Committee Chairman Kevin Brady (R-TX), Senate Majority Leader Mitch McConnell (R-KY), Finance Committee Chairman Orrin Hatch (R-UT), Treasury Secretary Steven Munchin, and Economic Council Director Gary Cohn.

Based on the Framework, the following changes (and others) have been discussed with respect to individual taxes:

[1] There will be 3 tax rates:

(a) 12%
(b) 25%
(c) 35%

[2] The standard deduction will be increased to $24,000 for a joint filer, $18,000 for a single taxpayer with a child and $12,000 for a single filer under the Framework.

[3] Personal exemptions will be eliminated.

[4] The Framework eliminates most itemized deductions, but retains tax incentives for home mortgage interest and charitable contributions.

[5] AMT would be eliminated.

[6] Estate tax and generation skipping transfer tax would be repealed. The Framework does not mention whether the gift tax would also be repealed. The Framework also

does not mention a new "death capital gains tax" or whether there would be a stepped up basis or carryover basis.

[7] As for changes that will impact closely-held businesses, the following proposed major changes appear in the Framework:

[a] Business income" from pass-through entities and sole proprietors will have a tax rate that is capped at a 25% tax rate. The Framework contemplates that measures will be adopted to prevent the recharacterization of "personal" income into "business" income to prevent wealthy individuals from avoiding the top personal tax rate. Tax rate for C corps would drop to 20%.

[b] There are lots of questions surrounding what will constitute "business" versus "personal" income and whether the current "reasonable compensation" standard used in the S corporation area for determining whether distributions should be recharacterized as wages for social security tax purposes would be applied. Given the definitional issues at hand, it's easy to imagine a slew of new regulations, IRS challenges, and court cases that would arise over the question of what is considered to be "reasonable" compensation and/or "personal" versus "business" income.

[8] Under the Framework, all U.S. businesses would be permitted to immediately expense investments in all tangible and intangible assets, except structures.

[9] The deduction for interest expense incurred by C corporations will be partially limited.

[10] The current law domestic production (Section 199) deduction will be eliminated.

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