# Pass Through Entities: Advanced Tax Issues

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- Thomas, Zollars & Lynch, Ltd.
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- Arizona Income Tax Guide

# Today's Session

- Two key passthroughs
  - Partnerships
  - S Corporations
- Look at
  - Troublesome issues
  - Recent developments

# Comparison: S Corporation & Partnerships

Module 8

#### Formation

- 80% Control Issue
- Treatment of liabilities and potential for gain

#### Liabilities

- Debt give partnership basis
- S corporation quirks
  - Limited to loan from shareholder
  - Repayment problem (Open account debt regulations)

#### Owners

- Partnership Broad
- S Corporation Limited

# Special Allocations

- §704 for partnerships
  - §704(b) for special allocations
  - §704(c) pre-contribution gains
- Neither apply or available for S corporations

# Insolvency

- Partnership test at partner level
- S Corporation test at corporate level
- Cover in detail shortly

# **Appreciated Property**

- S Corporation triggers gain [IRC §§301(b) or 336]
- Partnership basis attaches to asset

# Liquidation/Redemption

- Pure stock sale rules
- Partnership §736 rules portion can be deductible to partnership

# Terminations/ Revocation

- S Corporation
  - Inadvertent termination
  - Revocation
- Partnership terminations

# **Entity Selection**

Module I

# Rev Proc 2002-69

- Page I-I
- Practical option (as opposed to qualified joint venture)
- Limited to interest held solely as community property
- Deemed contribution/liquidation to change status

# LLCs - Domestic/ Foreign

- Page I-5
- Domestic entity
- Foreign entity

#### Form 8832

- p. I-6
- Initial election
- S election issues
- Late election relief
  - Corporate/partnership entity only
  - S Corporation issue

# Drop and Swap

- p I-12
- §1031 issue
- Rev Proc 2002-22
  - 15 factor test
  - Most entities will fail

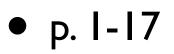
# **COD** Issues

- p. I-I4
  - §108 exclusions qualification at partner level
- Different definition of nonrecourse for
  - Partnership debt allocation
  - Testing for sale vs. COD

# LLC & Self-Employment Tax

- p. 16
- The rule you know that isn't a rule
- 1997 Proposed Regulations ("Stealth Tax)
- Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 TC 137

### LLC & Passive



- Activity tests limited partner
- IRS Losses
- Proposed regulations

#### Partnership Basics Module 2

#### Interest to Debtor

- p. 2-11
- New regulations [§1.108-8]
- General rule fair value of interest transferred
- Safe harbor (what will generally want to use)



#### • p. 2-11

 Deductible losses last item considered in calculation [Reg. 1.704-1(d)(2)]

#### Liabilities

- p. 2-13
- Always affect basis
- At risk rule may serve to limit losses

#### **Recourse Liabilities**

- p. 2-14
- Allocation errors common on K-Is
- Atomic bomb scenario
- Generally do not consider economic ability to fulfill commitment except for some disregarded entities
- Guarantees right to be repaid

### Nonrecourse Liabilities

- p. 2-18
- No one bears economic risk of loss [§752]
- Creditor has no to right to attach asset except that securing debt [§§108 & 1001]
- Difference key

### Nonrecourse Liabilities

- Allocation
  - Minimum gain
  - Share of §704(c) gain triggered by "deemed sale"
  - Reasonable method (most often profit or loss sharing ratio)

# Formation Traps

Module 3

# §704(c)

- p. 3-5
- Use a "reasonable method" to allocate
- General methods in regulations
  - Traditional method
  - Curative allocations
  - Remedial allocations

# §737 Gain Rule

- p. 3-13
- One place where fair value counts
  - Fair value of property > remaining basis and
  - Have §704(c) gain outstanding

### Services for Interest

- p. 3-14
- Sol Diamond issue
- Rev Proc 93-27 rule (p. 3-22)

#### Distributions

Module 4

#### Distributions

- Current vs. Liquidating
- Don't generally get FMV basis for assets, nor charged FMV against basis
- Difficult to trigger loss
  - Only in liquidations
  - No assets aside from cash, receivables and inventory

# Disproportionate Distributions

- p 4-12
- "Hot Assets" found at §751(b)
  - Unrealized receivables (includes virtually all recapture items
  - AppreciatedInventory (includes assets that would be §1231 except not held one year)

# Transactions Between Partnership & Partner

Module 5

#### Not as a Partner

- p. 5-4
- Partnership expenses (McLauchlan v. Commissioner, TC Memo 2011-289)
- Services for partnership
  - Timing
  - Employee (p. 5-21)

# Guaranteed Payments

#### • p. 5-18

- Must be made to a partner in his capacity as a partner
- Determined without references to partnership income
- Not be a distribution

#### Terminations & Mergers Module 6

#### **Technical Terminations**

- p. 6-3
- CPA Liability Risk Will You See Them in Time?
- Transfers which ones count and which ones don't?

# Consequences

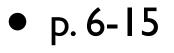


- Two returns, one due early
- Keep the same EIN
- Whole bunch of election type issues (including losing old §754 election)

# Merger

- p. 6-11
- Merger trumps technical termination
- Assets over get partnership interest for old interest
- Assets up partners get assets, form new partnership

#### Divisions



• Same basic rules as mergers

#### Section 701 Anti-Abuse Regulations Module 7

# **IRS's Catch-All**

- p. 7-1
- Transactions that subvert the "intent" of Subchapter K
- Patch until Congress can "fix" the IRC

#### Eligible Corporations Module 9

#### Trusts

- p. 9-4
- Eligible Trusts
- Elective Trusts
  - QSST
  - ESBT

# One Class of Stock

- p. 9-16
- Definition rights to
  - Dividends (state law, not IRC)
  - Liquidating distributions
- Debt exposure

# Making S Election

Module 10

# When to Make

- p. 10-1
- First 2 1/2 months for current year, otherwise starts following year
- New corporation don't elect too early

#### Election

- p. 10-2
- Can ask for extension on <u>consents</u> but not the <u>election</u> itself (p. 10-11 example)
- Invalid/Late Elections

#### Built-in Gains

Module 11

### Built in Gain Tax

- Back with full 10 year period
- Malpractice trap
  - Why didn't you consider S earlier?
  - Were proper appraisals obtained on all assets?

#### Shareholders' Basis

Module 12

# Basis Ordering

- p. 12-2 Distributions only after adding positives, before negatives
- p. 12-3 Special rule for IRD items
- p. 12-11- Election to reorder nondeductible
- Schedule E instructions request basis calculation if any loss is claimed

#### Debt Basis

- p. 12-5
- Strict shareholder rule
- Proposed "back to back" regulations [REG-134042-07]
- Repayment problems (p. 12-7)
- Open account debt (p. 12-7)

### Sale of Stock

- p. |2-||
- Per share/per day default
- Someone won't want to elect and election must be unanimous



Module 13

# Accumulated Adjustments Account

- Relevant only if corporation has E&P
- Corporate level account
- Computed "like" basis except
  - No tax exempt income or
  - No expenses related to tax exempt income

# Distributions -Corporate

- "Distribution" to extent of AAA
- Tax Dividend to extent of E&P
- "Distribution" for all remaining amount

#### Shareholder

- Dividends currently taxed, no affect on basis
- Distributions affect basis
  - Return of basis up to amount of basis then
  - Capital gain

# Post-Termination Transition Period

- p. |3-||
- I Year After S Election Ends
- 120 days after exam finalized
- 120 after S status finally determined to have been terminated

#### Other Issues

Module 14

# Reasonable Compensation

- p. 14-6
- Can't be unreasonably low
- Compensation set binding on taxpayers, but not on IRS

# Terminations & Revocations

Module 15

#### Revocation

- p. 15-1
- Prospective revocation (possible to rescind)
- Retroactive revocation (first 2 1/2 months)

#### Termination

- p. 15-2
- Exposure to CPA consider potential sources of termination
- Importance of shareholder's agreements

#### Reporting Module 16