

Pass Through Entities: Advanced Tax Issues

Edward K Zollars, CPA
ed@tzlcpas.com

Edward K Zollars

- Thomas, Zollars & Lynch, Ltd.
- Nichols Patrick CPE, Inc.
- Bisk Education (<http://www.cpeasy.com>)
- 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 1-1
- 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 1-5
- Domestic entity
- Foreign entity

Form 8832

- p. 1-6
- Initial election
- S election issues
- Late election relief
 - Corporate/partnership entity only
 - S Corporation issue

Drop and Swap

- p 1-12
- §1031 issue
- Rev Proc 2002-22
 - 15 factor test
 - Most entities will fail

COD Issues

- p. 1-14
 - §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

- p. 1-17
- 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)

Basis

- 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-1s
- 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)
 - Appreciated Inventory (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

- p. 6-4
- 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

- p. 6-15
- 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 consents but not the election itself (p. 10-11 example)
- Invalid/Late Elections

Built-in Gains

Module II

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. 12-11
- Per share/per day default
- Someone won't want to elect and election must be unanimous

AAA

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. 13-11
- 1 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