

THE RESTRUCTURING OF AGRIBUSINESS OPERATIONS—FROM A TAX PERSPECTIVE[©]

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I. INTRODUCTION

A. *Changing Legal and Tax Environment*

Rapid changes have occurred and are continuing to occur in the taxation of business organizations, due to changes in the Internal Revenue Code¹ which affect business, the finalization of check-the-box regulations,² the enactment of legislation

1. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (codified as amended in scattered sections of 26 U.S.C.).

2. See Treas. Reg. § 301.7701-2 (1996); Treas. Reg. § 301.7701-3 (as amended in 1998) See generally Susan Kalinka, *The Louisiana Limited Liability Company Law After "Check-The-Box,"* 57 LA. L. REV. 715 (1997) (explaining that recent changes in the income tax area have affected some types of business organizations and that the check-the-box election is not available to all business organizations). See also Robert R. Keatinge, *Corporations, Unincorporated Organizations, and Unincorporations: Check The Box and the Balkanization of Business Organizations*, 1 J. SMALL & EMERGING BUS. L. 201, 202 (1997) (noting the tax and non-tax rules which, after dramatic changes in the Internal Revenue Code apply to business organizations); Carol J. Miller et al., *Limited Liability Companies Before and After The January 1997 IRS "Check-The-Box" Regulations: Choice of Entity and Taxation Considerations*, 25 N. KY. L. REV. 585, 585-613 (1998).

which authorizes alternatives to the corporate form of doing business,³ and the consolidation and growth of agribusiness entities.

B. Analytical Structure

Agribusiness clients frequently ask their estate and income tax planners several common questions including: What type of business structure should I have; Should I incorporate; or is there a better form of organization for conducting business than any organization's present form? In order to answer a client's questions, the tax advisor must consider the following:

- a. The client's goals, which usually include the reduction of income, self-employment, social security and/or estate taxes; liability protection for the investor; the shift of income and profits to other family members; and the creation of retirement assets. Does the current business structure maximize the income, social security, self-employment, and estate tax savings?⁴
- b. The type of business the client conducts such as agricultural service, manufacturing, or operation;
- c. The client's current legal structure for operating the business. Does the legal structure shield individually-owned and other assets in a fairly safe industry from the liabilities of an inherently dangerous business?
- d. The future sale of the business and the likelihood that realized tax gains will be recognized and subject to double taxation;⁵
- e. The client's desire to retain control;⁶
- f. The existence of a business succession plan, and whether the business plan and current legal structure facilitates the continuation of the business after the current generation no longer manages the business;
- g. The business' long-term economic prospects;⁷

3. For a discussion of the tax treatment of limited liability partnerships, see ALAN R. BROMBERG & LARRY E. RIBSTEIN, LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT § 7.05 (1995). See generally Joseph M. Mona, *167 Advantages of Using a Limited Liability Company in an Estate Plan*, 25 Est. Plan. 167 (1998) (expressing that the LLC when compared with other entities may be the preferred entity for estate planning purposes).

4. For example, the income tax for the family group may be reduced by spreading income among family members. See I.R.C. § 1 (1994 & Supp. III 1997). Additionally, estate taxes may be reduced by utilizing minority and lack of marketability discounts for business interests and the new family owned business deduction. See S. Stacy Eastland, *The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Partnerships In Estate Planning* (seminar outline from the Thirty-third Annual Philip E. Heckerling Institute on Estate Planning—Fundamentals Program) (on file with author).

5. See discussion *infra* Part II.B.

6. Most older family members want to reduce taxes but retain control. In many cases, these two goals are incompatible.

7. If substantial growth is forecast for the business, then part of the business ownership perhaps should be transferred through gifts to younger family members to reduce future estate taxes.

h. The shifting of future growth to other family members through the use of various business structures.

The client's tax and legal structures require continuous analysis and monitoring due to potential changes in the agribusiness operation, including the present business which may expand or acquire other businesses, and/or changes in the tax and/or state laws. Thus, the choice of entity issue requires ongoing analysis for both new and existing businesses.⁸

II. RESTRUCTURING

A. *Organization (Entity) Choices*

1. *Alternatives*

The basic formats in which an agribusiness may be conducted under present law include the following: sole proprietorship, general partnership, limited partnership, limited liability company, limited liability partnership, regular ("C") corporation, S corporation, and limited liability limited partnership.⁹ As will become evident from the common fact pattern recommendations presented later in this article, some businesses should be operated in a multi-entity format.¹⁰

The following sections present an analysis of the basic state and tax law characteristics of each entity and an application of the entity analyses to eleven common agribusiness fact patterns.

2. *Sole Proprietorship*

a. *State Law*

The simplest form of business entity is the sole proprietorship.¹¹ The assets of a sole proprietorship are owned by one person who has full control and liability for all aspects of the business.¹² Since no other person is involved in the ownership

8. The choice of entity format should be made only after considering a number of factors including: liability protection; form of management; continuity after the death of an investor, partner, or member; transferability of the ownership interest; and income and estate taxes. The tax factor may be the tie-breaker in arriving at a decision, but in most cases should not be the sole determinant.

9. See generally William P. Streng, *Choice of Entity*, 700 TAX MGMT. (BNA) (1993) (discussing tax implications and other considerations in choosing the most advantageous business entity).

10. The multi-entity format may reduce income, social security, self-employment and estate taxes. See *infra* Part II.L.

11. See Streng, *supra* note 9, at iii.

12. See *id.* at A-3. Since no limited liability entity is involved, the sole proprietor's

of the sole proprietorship, all profits, losses, and tax effects flow to the sole proprietor and the sole proprietor has full control of the business.¹³ Although many agribusinesses operate as sole proprietorships, these organizations would be well advised to consider another business format in order to shelter non-business (personal) assets from the sole proprietor's business liabilities.¹⁴ Upon the death of an individual sole proprietor, the business will be operated by an executor or other court-appointed officer.¹⁵

b. *Taxation*

The income, gains, deductions and losses of a sole proprietorship are reported by the sole proprietor.¹⁶ Business profits are subject to self-employment and Medicare taxes.¹⁷ If the business is sold, the gain or loss will be reported by the sole proprietor.¹⁸ The sole proprietor receives none of the tax-free benefits that an employee receives¹⁹ and is precluded from reaping the benefits of using the graduated tax brackets of a regular corporation.²⁰

c. *Conclusion*

Due to unlimited liability potential and minimal tax advantages, few, if any, agribusiness operations should be organized as sole proprietorships.

3. *General Partnership*

a. *State Law*

When two or more persons agree to carry on a business for profit, a general partnership is formed.²¹ The profits and losses are allocated for partnership purposes pursuant to the terms of a partnership agreement.²² In order to avoid future disagreements over the partnership's agreement terms, a written partnership agreement should always be executed. The partners control the partnership, unless

business and personal assets are exposed to tort, contract, and other liability claims. *See id.* at iii.

13. *See id.* at A-3.

14. *See id.* at iii.

15. *See id.* at A-96 (emphasizing that if an entity interest has not been transferred prior to death then its value must be established for federal estate tax purposes). Unless there is a competent successor to continue the business, the value of the business is likely to diminish sharply.

16. *See* I.R.C. § 61 (1994); I.R.C. § 162 (1994 & Supp. III 1997).

17. *See* I.R.C. § 1401 (1994); I.R.C. § 1402 (1994 & Supp. III 1997).

18. *See* I.R.C. § 1001 (1994 & Supp. III 1997).

19. For an example of such benefits, see I.R.C. §§ 79, 105 (1994) and I.R.C. §§ 106, 119, 132 (1994 & Supp. III 1997).

20. *See* I.R.C. § 11(b) (1994).

21. *See* UNIF. PARTNERSHIP ACT § 202 (amended 1997), 6 U.L.A. 27 (Supp. 1999).

22. *See id.* § 401 at 51.

the partnership agreement specifies otherwise. Each of the partners is jointly and severally liable for the liabilities of the partnership.²³

b. *Taxation*

For tax purposes, the profits and losses are allocated to the partners pursuant to the partnership agreement, unless the allocation has no substantial economic effect.²⁴ A general partner's share of the partnership profits is subject to self-employment taxes.²⁵ Because a partner is usually not regarded as an employee for tax purposes, partners are not allowed to exclude employee benefits from gross income.²⁶ Furthermore, the general partnership cannot utilize the graduated tax brackets as does a corporation.²⁷ Exhibit 1 compares the tax characteristics of organizations taxed as partnerships with the tax characteristics of S corporations and C corporations.

c. *Conclusion*

Since a general partnership exposes its partners to unlimited liability and offers few tax advantages, the general partnership form of organization is not a preferred choice for most agribusiness operations.²⁸

23. See *id.* §§ 305(a), 306(a) at 51. A general partnership could consist of several limited liability organizations. See Streng, *supra* note 9, at A-3. For example, a corporation and a limited liability company could form a general partnership and still shield the investors of the corporation and limited liability company from liability. However, several states have laws which restrict ownership of farm land to designated individuals or organizations. See generally Keith D. Haroldson, *Two Issues in Corporate Agriculture: Anticorporate Farming Statutes and Production Contracts*, 41 *DRAKE L. REV.* 393 (1992) (explaining that nine states prohibit corporate farms). See also NEB. CONST. art. XIII, § 8(1); OKLA. CONST. art. XXII, § 2; IOWA CODE § 9H.4 (1999); KAN. STAT. ANN. § 17-5904 (1995 & Supp. 1998); MINN. STAT ANN. § 500.24(3) (West 1990 & Supp 1999); MO. ANN. STAT. § 350.015 (West 1991 & Supp. 1999); N.D. CENT. CODE § 10-06-01 (Michie 1995); S.D. CODIFIED LAWS § 47-9A-3 (Michie 1991); WIS. STAT. ANN. § 182.001 (West 1992).

24. See I.R.C. § 704(a), (b)(2) (1994). For an in-depth analysis of the taxation of partnerships, including all forms of organizations which are taxed as partnerships, see WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (3d ed. 1997).

25. See I.R.C. § 1401 (1994); I.R.C. § 1402 (1994 & Supp. III 1997).

26. See I.R.C. §§ 79, 132(a) 119(a), 125(a) (1994); I.R.C. § 106(a) (Supp. III 1997). But see *Armstrong v. Phinney*, 394 F.2d 661, 662-63 (5th Cir. 1968), where the court indicated that a partner may be an employee of a partnership for section 119(a) purposes. Compare with *Dilts v. United States*, 845 F. Supp. 1505, 1510 (D. Wyo. 1994), which distinguished *Armstrong v. Phinney* and held that section 119 was not applicable to the shareholders of an S corporation.

27. See I.R.C. §§ 11(b), 701-703 (1994).

28. Some states permit a general partnership to elect limited liability partnership protection. See *infra* Part II.A.6.

4. *Limited Partnership*

a. *State Law*

A limited partnership is required to have a general partner and at least one limited partner.²⁹ The general partner manages the partnership³⁰ and is personally liable for the limited partnership's debts and liabilities.³¹ A limited partner is liable only for contributions required by the partnership agreement, unless the limited partner takes an active role in the limited partnership³² or personally guarantees the limited partnership's debts and liabilities.³³ In order to form a limited partnership, a certificate of limited partnership must be filed with the appropriate state office.³⁴ Profits and losses are allocated pursuant to the provisions of a limited partnership agreement which should be in writing to avoid possible conflicts among partners.³⁵

b. *Taxation*

For years, a major issue concerning limited partnerships was whether the limited partnership would be taxed as a partnership or corporation.³⁶ In 1996, the Treasury Department issued "check-the-box" regulations³⁷ which provide that a limited partnership will be regarded as a partnership for tax purposes, unless the limited partnership "checks-the-box" and elects to be regarded as a corporation for tax purposes.³⁸

29. See REVISED UNIF. LTD. PARTNERSHIP ACT § 101(7) (amended 1985), 6A U.L.A. 61 (1995).

30. See *id.* § 403(a) at 177.

31. See *id.* § 403(b) at 177. A limited partnership in some states may file with the appropriate state office an election to be a limited liability partnership which may shield a general partner from some or most personal liability. See LEWIS D. SOLOMAN & ALAN R. PALMITER, CORPORATIONS: EXAMPLES & EXPLANATIONS § 2.2.5, at 24 (1999).

32. See REVISED UNIF. LTD. PARTNERSHIP ACT, *supra* note 29, § 303, at 144.

33. See *id.* § 303(3) at 144.

34. See *id.* § 201 at 95.

35. See *id.* § 105 at 88.

36. See *Larson v. Commissioner*, 66 T.C. 159 (1976); Rev. Rul. 95-2, 1995-1 C.B. 221.

37. See Louis A. Mezzullo et. al., *Choice of Family Business Entity for Estate Planning Purposes*, SEO8 ALI-ABA 269, 275 (1999); Treas. Reg. § 301.7701-3(a) (as amended in 1998). Under regulations adopted by the Treasury Department, limited partnerships, limited liability companies, limited liability limited partnerships, and limited liability partnerships may elect to be regarded as corporations for tax purposes. See Treas. Reg. § 301.7701-3(a) (as amended in 1998). If the limited partnership wants to be regarded as a corporation (association), then the limited partnership must file Internal Revenue Service Form 8832 and select an effective date, which cannot be more than 75 days preceding the election or more than 12 months after the election is filed. See Treas. Reg. § 301.7701-2 (1996).

38. See Treas. Reg. § 301.7701-3(a), (c). Internal Revenue Service Form 8832 must be filed for a limited partnership to elect corporate taxation treatment. See *id.* § 301.7701-3(c).

The income, losses, gains, deductions, and credits of a limited partnership are allocated to the partners pursuant to the provisions of the limited partnership agreement, unless the allocation lacks substantial economic effect.³⁹ An individual general partner is subject to self-employment taxes on the partner's share of the partnership profits.⁴⁰ A limited partnership is unable to offer tax-free employee benefits to its partners,⁴¹ nor can it take advantage of the graduated corporate tax brackets.⁴²

Limited partnerships provide an excellent opportunity for estate planning through the gifting of limited partnership interests.⁴³ Such gifts may qualify for a \$10,000 per year per beneficiary gift tax exclusion⁴⁴ as well as lack of marketability and minority discounts.⁴⁵

c. *Conclusion*

The creation of limited partnerships should be considered in agribusiness family estate planning, particularly if the shifting of business income and/or future potential growth to children and grandchildren are an important goal of the client.

5. *Limited Liability Company*

a. *State Law*

One or more persons may form a limited liability company by filing articles of organization with the designated state authority.⁴⁶ The income, losses, gains,

39. See I.R.C. § 704(b)(2) (1994).

40. See I.R.C. § 1401 (1994); I.R.C. § 1402(a) (Supp. III 1997). The Treasury Department proposed a regulation to treat a limited partner of a limited partnership as a general partner if the limited partner was personally liable for partnership debts or participated more than 500 hours per year in the partnership's trade or business, or had the authority from the partnership to enter into contracts on the partnership's behalf. See Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702, 1703 (1997). However congress passed legislation which prohibited the Treasury Department from issuing temporary or final regulations on the limited partner/self employment tax issue. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882 (1997).

41. See I.R.C. §§ 79, 105 (1994); I.R.C. §§ 106, 119, 132 (1994 & Supp. III 1997).

42. See I.R.C. § 11(b) (1994).

43. Gifts of limited partnership interests are preferred to gifts of fractional interests in land because one organization (the limited partnership) continues to own the business.

44. See I.R.C. § 2503(b) (1994 & Supp. III 1997).

45. See S. Stacy Eastland, *Is There Life After Death? Yes, Especially if the Estate Becomes a Partner: Post Mortem Use of Partnerships*, in THIRTIETH PHILLIP E. HECKERLING INST. ON EST. PLAN., ¶ 1102.5 (Matthew Bender ed., 1996).

46. See LIMITED LIABILITY COMPANY ACT §§ 201-03, 6A U.L.A. 443-46 (1995). For a state-by-state analysis of Limited Liability Company Act passage and tax classification, see LIMITED LIABILITY COMPANIES: FORMATION, OPERATION, AND CONVERSION, § 3.1, at 60, app. A, at 279-86 (Robert W. Wood ed., 1993 & Supp. 1998)[hereinafter LIMITED LIABILITY COMPANIES]; *Distributions of*

deductions, and credits are split among the limited liability company's members pursuant to the provisions of the operating agreement.⁴⁷ The operating agreement should be in writing and designate the relationship of the members to each other. A limited liability company is extremely flexible and can be operated like a general or limited partnership or corporation, depending upon the provisions of the operating agreement. A member of a limited liability company is liable only for those contributions provided in the operating agreement⁴⁸ unless the limited liability company makes unlawful distributions⁴⁹ or the member agrees to accept personal liability for the limited liability company's debts—For example, a member may execute a personal guaranty.⁵⁰

If an agribusiness organization operates in several states as a limited liability company, then the laws of each state should be reviewed for purposes of ensuring compliance and limited liability protection.⁵¹

b. *Taxation*

The same tax analysis which applied to a limited partnership applies to a limited liability company.⁵² However, the lack of marketability or minority discount⁵³ for estate and gift planning purposes has not been established and the member(s) responsible for management of the limited liability company may be subject to self-employment taxes.⁵⁴

c. *Conclusion*

Since limited liability companies shelter members from unlimited liability and allow for flexibility in matters involving state and tax law,⁵⁵ the limited liability company should be the entity of choice for many agribusinesses, unless the agribusiness organization operates in several states. A multi-state operation will require an analysis to determine the effects of the various state laws on liability and taxation issues.⁵⁶

Income, Limited Liability Company Guide (CCH) ¶ 6015, at 1516 (Oct. 1997).

47. See *Distributions of Income*, Limited Liability Company Guide (CCH) ¶ 6015, at 1516 (Oct. 1997).

48. See *Formation, Operation and Dissolution*, Limited Liability Company Guide (CCH) ¶ 9013, at 2113 (Sept. 1996).

49. See *id.* ¶ 9013, at 2113-14.

50. See *Scope*, Limited Liability Company Guide (CCH) ¶ 9010, at 2111-12.

51. See *Multistate Transactions*, Limited Liability Company Guide (CCH) ¶ 9020, at 2115 (Sept. 1996).

52. See *infra* Part II.A.4.b.

53. See discussion *infra* note 4. It is too early to ascertain whether the limited partnership discount cases will apply to limited liability company interests.

54. See I.R.C. § 1401 (1994); I.R.C. § 1402 (1994 & Supp. III 1997).

55. See LIMITED LIABILITY COMPANIES, *supra* note 46, § 1.6, at 6-7.

56. Some states may not recognize limited liability companies for tax purposes or on

6. *Limited Liability Partnership*

a. *State Law*

A limited liability partnership is a general partnership which elects to register under state law to operate as a limited liability partnership.⁵⁷ The limited liability partnership may shield one partner from the acts of other partners.⁵⁸ Otherwise, the limited liability partnership operates as, and demonstrates the characteristics of, a general partnership.⁵⁹

b. *Taxation*

A limited liability partnership is taxed as a general partnership, thus the tax analysis of the general partnership presented earlier applies.⁶⁰

7. *C Corporation*

a. *State Law*

A C corporation is formed by filing articles of incorporation with the appropriate state office.⁶¹ The corporation is governed by the articles of incorporation,⁶² bylaws,⁶³ and shareholder agreements.⁶⁴ The corporation has three distinct bodies: shareholders who invest in shares of stock, elect the board of directors, and adopt bylaws; directors who make policy decisions; and officers who manage the daily affairs of the corporation. The articles of incorporation may provide for different classes of stock.⁶⁵ Examples of stock classifications include common (voting and/or nonvoting) and preferred (voting and/or nonvoting, participating or non-participating, and cumulative or non-cumulative).⁶⁶ Shareholders receive a return on their investments through dividends and liquidating

certain liability issues. *See id.* §§ 1.6, 1.9, at 6-7, 11.

57. *See* Streng, *supra* note 9, at A-5. Almost all states have passed some form of a limited liability partnership amendment. *See id.* at A-4 & n.33.

58. *See id.* at A-5. Some states have amended their limited liability partnership laws to provide protection to investors from all partnership liabilities and debts. *See* SOLOMAN & PALMITER, *supra* note 31, § 2.2.5, at 24 (stating that recent state statutes allow the creation of limited liability limited partnerships, which can even limit the liability of the general partner).

59. *See* Streng, *supra* note 9, at A-4.

60. *See infra* Part II.A.3.b.

61. *See* MODEL BUS. CORP. ACT § 1.20(a), (i) (1998).

62. *See id.* § 2.02.

63. *See id.* § 2.06.

64. *See id.* § 7.32.

65. *See id.* § 6.01(c).

66. *See id.*

distributions.⁶⁷ A shareholder is liable only for his or her initial contribution for shares,⁶⁸ unless the shareholder receives an unlawful distribution⁶⁹ or personally guarantees a corporate obligation.⁷⁰

b. *Taxation*

A C corporation pays income tax on its taxable income⁷¹ and, thus, is subject to the graduated tax brackets applicable to corporations.⁷² Employees of a C corporation usually receive numerous benefits paid and deducted by the corporation, but these are not included in the employee's gross income.⁷³ Distributions from a regular corporation may be subject to taxation at the shareholder level either as a dividend⁷⁴ or as a liquidating distribution.⁷⁵ The primary tax disadvantages of a C corporation include the following:

a. The double taxation of dividend distributions. For example, the corporation pays tax on its taxable income⁷⁶ and the shareholders may be required to include the distribution in gross income.⁷⁷

b. The sale or distribution of assets may generate a taxable gain to the corporation⁷⁸ and the liquidating distribution will result in a gain to the shareholder to the extent that the liquidating distribution exceeds the shareholder's adjusted basis in the shareholder's stock.⁷⁹

67. *See id.* § 6.40.

68. *See id.* § 6.22(a).

69. *See id.* § 8.33(b)(2).

70. *See id.* § 6.22(b).

71. *See* I.R.C. §§ 11(a), 61 (1994); I.R.C. § 63 (1994 & Supp. III 1997). For a general discussion of the tax issues of a corporation and its shareholders, see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (6th ed. 1998).

72. *See* I.R.C. § 11(b) (1994).

73. *See* I.R.C. §§ 79(a), 105, 106 (1994); I.R.C. §§ 119, 125, 132 (1994 & Supp. III 1997). Corporations may deduct the benefits to the extent the benefits, bonuses and salary do not exceed reasonable compensation. *See* I.R.C. § 162(a)(1) (1994).

74. *See* I.R.C. §§ 301(a)-(c), 316 (1994).

75. *See id.* §§ 331, 332.

76. *See id.* § 11(b).

77. *See id.* §§ 61(a)(1), 301(a)-(c), 316.

78. If the corporation distributes an appreciated asset in liquidation, the distribution is treated as a sale by the liquidating corporation to its shareholder(s) at fair market value which will result in gain to the distributing corporation if the fair market value of the asset exceeds the corporation's adjusted basis in the asset. *See id.* §§ 336(a), 1001(a).

79. *See id.* §§ 1001(a), 331.

c. *Conclusion*

The C corporation offers the investor protection from business liabilities to the maximum extent possible, and the tax advantages of graduated tax brackets and tax free fringe benefits for employees; however, the possibility of double tax may negate the use of C corporations for businesses with appreciated or appreciating assets.

8. *S Corporation*

a. *State Law*

An S corporation is a corporation which has elected to be treated as a pass-through entity for most income tax purposes.⁸⁰ Certain consolidated groups of corporations may also elect to be treated as an S corporation.⁸¹ The election has no impact on the existence of the corporation under state corporate law.

b. *Taxation*

A corporation classified as a small business corporation⁸² can elect to operate as an S corporation.⁸³ In order for a corporation to be classified as a small business corporation, the corporation must meet all of the following criteria:

- a. The corporation is a domestic corporation.⁸⁴
- b. The corporation is not an ineligible corporation (e.g., is not an insurance company, DISC, or a financial institution using the reserve method for bad debts).⁸⁵
- c. The corporation has 75 or fewer shareholders.⁸⁶
- d. The corporation's shareholders are individuals, estates, or certain trusts (e.g., electing small business trust,⁸⁷ a qualified subchapter S trust,⁸⁸ or revocable trust).⁸⁹
- e. No shareholder is a nonresident alien.⁹⁰

80. See Streng, *supra* note 9, at A-7 to A-8.

81. See I.R.C. § 1361(b)(3) (Supp. III 1997).

82. See I.R.C. § 1361(b) (1994 & Supp. III 1997).

83. See I.R.C. § 1362(a)(1) (1994).

84. See I.R.C. § 1361 (b)(1) (1994 & Supp. III 1997)

85. See I.R.C. § 1361(b)(2) (Supp. III 1997).

86. See *id.* § 1361 (b)(1)(A).

87. See *id.* § 1361(e).

88. See I.R.C. § 1361(d) (1994).

89. See I.R.C. § 1361 (b)(1)(B) (Supp. III 1997).

90. See *id.* § 1361(b)(1)(C).

f. The corporation has no more than one class of stock; however, the corporation may have several classes of common stock as long as the only difference between the several stock classes is in voting rights.⁹¹

A corporation which desires to operate as an S corporation must file a timely election with the Internal Revenue Service.⁹² The election must be filed on or before the fifteenth day of the third month of the start of the corporation's tax year in order for the election to be effective for the current tax year.⁹³ The election remains in effect until: revoked by the corporation and its shareholders; the election is terminated because the corporation no longer qualifies as a small business corporation; or has accumulated earnings and profits and passive investment income exceeds twenty-five percent of gross receipts for three consecutive tax years.⁹⁴

The income, deductions, gains, losses, and credits of an S corporation pass through the corporation⁹⁵ and are allocated to shareholders based upon a percentage of share ownership.⁹⁶ An S corporation is generally not subject to income taxes.⁹⁷ However, if the corporation is a regular corporation and converts to S corporation status, then the corporation may be subject to a built-in gains tax⁹⁸ or an excess passive income tax.⁹⁹

Under present law, distributions, except for compensation, from an S corporation are not subject to social security or self-employment tax,¹⁰⁰ and are subject to inclusion in gross income only to the extent that the distributions exceed the shareholder's basis in his or her S corporation shares¹⁰¹ or, if the corporation has accumulated earnings and profits, the distribution exceeds the accumulated adjustment account and, in some cases, the shareholder's adjusted basis in the S corporation shares.¹⁰² Additionally, income which passes through an S corporation

91. *See id.* §§ 1361(b)(1)(D), 1361(c)(4). Note that debt of the corporation may be treated as a second class of stock unless it qualifies under the straight debt safe harbor or is otherwise regarded as debt for tax purposes. *See id.* § 1361(c)(5)(A).

92. *See* I.R.C. § 1362(b) (1994 & Supp. III 1997). The S corporation election is made by timely filing a completed Internal Revenue Service form 2553. A late election (i.e. an election filed after the fifteenth day of the third month of the start of the corporation's tax year) will be effective for the subsequent tax year unless the internal Revenue Service determines that reasonable cause exists for the late election *See* I.R.C. § 1362(b)(1)-(4) (1994); I.R.C. § 1362(b)(5) (Supp. III 1997).

93. *See* I.R.C. § 1362(b)(1)(B) (1994).

94. *See* I.R.C. § 1362(d)(1)-(d)(2) (1994); I.R.C. § 1362 (d)(3)(A) (Supp. III 1997).

95. *See* I.R.C. § 1366(a)(1) (1994).

96. *See id.* §§ 1366(a), 1377(a)(1).

97. *See id.* § 1363(a).

98. *See* I.R.C. § 1374 (1994 & Supp. III 1997).

99. *See id.* § 1375.

100. The distributions are not earned income, thus the social security tax and the self-employment tax do not apply. *See* I.R.C. § 1402(b) (1994); I.R.C. § 3121(a) (1994 & Supp. III 1997).

101. *See* I.R.C. § 1368(a)-(b) (1994).

102. *See id.* § 1368(c).

to its shareholders is not earned income and thus is not subject to self-employment or social security tax.¹⁰³

c. *Conclusion*

Since an S corporation provides limited liability protection and some tax benefits, it is a viable alternative to limited partnerships and limited liability companies for multi-state operations. Compared with C corporations, S corporations shield investors from liabilities of the business and avoid most of the double tax problems associated with C corporations. Thus, S corporations should be considered as a viable organization form for many agribusinesses.

B. *Common Fact Pattern I—C Corporation—
Tax Disaster—Sale/Liquidation*

1. *Facts*

Agrico Inc., a C corporation, owns farm land with a value of \$1,000,000 and has an adjusted basis of \$200,000. All of the stock of Agrico Inc., is owned by Pa and Ma Farmer (PMF). PMF have a \$10,000 basis in their Agrico Inc., shares. The children of PMF have no interest in farming the land or continuing Agrico Inc. PMF want to reduce income and estate taxes.

2. *Problem*

If PMF die owning the Agrico Inc., shares, then the basis of their shares will increase to the value of the shares at the date of death of the survivor.¹⁰⁴ The liquidation of Agrico Inc., by the children will result in a gain to Agrico Inc., of \$800,000¹⁰⁵ and Federal income taxes of approximately \$272,000.¹⁰⁶ Thus, the net proceeds received by the children will be \$728,000, instead of \$1,000,000.¹⁰⁷ Furthermore, the value of PMF's estate will include the full value, \$1,000,000,¹⁰⁸ of the Agrico Inc., stock.

103. *See id.* § 1368(a)-(c).

104. *See* I.R.C. § 1014(a)(1), (b) (1994 & Supp. III 1997).

105. *See* I.R.C. §§ 1001(a)-(b), 336(a) (1994). Amount realized (\$1,000,000) less adjusted basis (\$200,000) equals gain (\$800,000).

106. *See* I.R.C. § 11 (1994 & Supp. III 1997).

107. If the value of the stock is \$1,000,000 for estate tax purposes, and the shareholders receive an income tax basis of \$1,000,000, the children will have a capital loss of \$272,000. *See* I.R.C. § 1014(a) (Supp. III 1997); I.R.C. §§ 1001, 1221, 1222 (1994). The capital loss will be subject to the restrictive rules on deduction of capital losses. *See* I.R.C. §§ 1211, 1212 (1994).

108. *See* I.R.C. § 2031(a) (1994). The stock value may be reduced if special use valuation is elected under I.R.C. section 2032A or if the small business deduction is elected under I.R.C. section 2033A. *See* I.R.C. § 2032A (Supp III 1997); I.R.C. § 2033A (Supp. III 1997) *amended by*

3. *Potential Restructuring Solutions*

Assuming that Agrico Inc., qualifies for S corporation status,¹⁰⁹ Agrico Inc., and its shareholders should consider electing such status.¹¹⁰ The purpose of electing S corporation status is to eliminate the potential for double taxation upon the sale of the farm land and assets and, perhaps, to recognize no gain upon the sale of the agribusiness. If the farm land and other assets are sold at least ten years after the S corporation has been in effect, then the gain will pass through to Agrico Inc.'s shareholders,¹¹¹ increasing the shareholders' basis in their shares.¹¹² If the shareholders inherited their shares from PMF, the shareholders' basis in their shares will increase to the shares' date of death value.¹¹³ Thus, the basis of the shares, after the sale or distribution of assets, will be the date of death value¹¹⁴ plus the increase in basis due to the pass through of gain from the sale or distribution of the farm land and other assets.¹¹⁵ The subsequent adjusted basis of the Agrico Inc., shares should exceed the fair market value of the distributed property liquidation proceeds received by the shareholders, resulting in a long-term capital loss to the shareholders.¹¹⁶

The shareholders will want both the liquidation loss, and the sale of the farm land and other assets to occur in the shareholders' same tax year in order for the liquidation loss to offset the gain from the sale of the farm land.¹¹⁷ However, if the sale occurs in year one and the liquidation loss occurs in year two, the long-term capital loss from the liquidation will not offset the section 1231 gain from the prior

Internal Revenue Reform Act of 1998, Pub. L. No. 105-206, § 6007(b)(1)(A), 1998 U.S.C.C.A.N. (112 Stat. 685) 807 (redesignating § 2033A to § 2057). However, because the farm land will be sold prior to the end of the ten-year holding period required for both special use valuation and the small business deduction, the reduction in value or deduction provisions perhaps should not be elected. *See* I.R.C. § 2032A (Supp. III 1997); I.R.C. § 2033A (Supp. III 1997) *amended by* Internal Revenue Reform Act of 1998, Pub. L. No. 105-206, § 6007(b)(1)(A), 1998 U.S.C.C.A.N. (112 Stat. 685) 807 (redesignating § 2033A to § 2057).

109. *See* I.R.C. § 1361(a) (1994). Agrico Inc., must qualify as a small business corporation and file a timely election. *See* I.R.C. §§ 1361(b), 1362(a) (1994 & Supp. III 1997).

110. *See id.* § 1362(a)-(b).

111. *See id.* § 1363(a)-(b). *See, e.g.,* *Byrne v. Commissioner*, 361 F.2d 939, 942 (7th Cir. 1966).

112. *See* I.R.C. § 1367(a)(1) (1994 & Supp. III 1997).

113. *See* I.R.C. § 1014(a)(1), (b)(1) (Supp III 1997). The estate can elect to value the estate assets, including the stock, at the date of death value or alternatively, use the six months after the date of death value. *See id.* §§ 2031, 2032.

114. *See* I.R.C. § 1014(a) (Supp. III 1997); I.R.C. § 1014(b) (1994).

115. *See* I.R.C. § 1366(a) (1994 & Supp. III 1997); I.R.C. § 1367(a)(1) (1994).

116. *See* I.R.C. §§ 331, 1222(4), 1223(11) (1994).

117. The gain from the sale of the farm land should be a section 1231 gain. Thus, it is a long-term capital gain, provided that the section 1231 gains exceed the section 1231 losses. The capital losses can be used to offset capital gains plus \$3,000/year, if capital losses exceed capital gains by at least \$3,000. *See id.* § 1211(b). If capital losses are not used in a year, they can be carried forward to the next tax year. *See id.* § 1212(b).

year because the capital loss cannot be carried back.¹¹⁸ Therefore, the capital loss must be used against future capital gain or gradually used at the rate of \$3,000 per year.¹¹⁹

Before deciding whether an S corporation election is a solution to the double tax problem, Agrico Inc.'s shareholders and advisors must consider several potential problems including the following:

- a. Most C corporations, including Agrico Inc., have appreciated assets. If these appreciated assets are sold within ten years of the S corporation election, then the gain is subject to inclusion in Agrico, Inc.'s gross income as well as subject to the highest corporate tax rate—thirty-five percent.¹²⁰ Thus, if Agrico Inc., elects S corporation status and sells its farm land and other assets within ten years of the effective date of the S corporation election, then all or part of the gain on the appreciated property will be subject to the thirty-five percent tax rate.¹²¹
- b. The conversion from C corporation status to S corporation status may trigger LIFO inventory recapture—assuming the C corporation used the LIFO inventory method.¹²²
- c. Agrico Inc., may be subject to an excess passive investment income tax at the highest corporate rate if: its passive investment income exceeds twenty-five percent of its gross receipts and; it has accumulated C corporation earnings and profits.¹²³ Furthermore, if the excess passive investment income continues for three consecutive years, then the S corporation election is terminated.¹²⁴

Due to the disastrous tax effects of a C corporation's sale of assets and subsequent liquidation, and the S corporation election problems of built-in gain tax and excess passive investment income taxes, PMF may consider converting the C corporation to either a limited liability company or a limited partnership. For income tax purposes, the conversion from C corporation status to partnership status would be regarded as a liquidation, which may result in gain to the corporation as well as to the corporation's shareholders.¹²⁵

118. *See id.* §§ 1211(b), 1212(b).

119. *See id.* § 1211(b).

120. *See id.* § 1374(a)-(b).

121. The built-in gain which is subject to taxation to Agrico, Inc. is limited to the built-in gain on the first day of the first taxable year for which an S corporation election was effective. *See id.* § 1374(d)(1), (d)(3)(B). Thus, in order to limit the amount of built-in gain, Agrico, Inc. should have its assets appraised as of the first day the S corporation election is effective.

122. *See id.* § 1363(d).

123. *See* I.R.C. § 1375(a) (Supp. III 1997).

124. *See* I.R.C. § 1362(d)(3) (1994 & Supp. III 1997).

125. *See* Priv. Ltr. Rul. 95-43-017 (Oct. 27, 1995) (explaining the gain of an S corporation in liquidation when converting to a partnership and the same result would be created if it were a 'C' corporation liquidating to become a partnership); I.R.C. §§ 331, 336 (1994).

C. *Common Fact Pattern II—Sibling Disputes*

1. *Facts*

The facts are the same as those presented in Common Fact Pattern I, except that PMF have a son and daughter who are involved in the farm operation. The son and daughter disagree on how the farm should be operated and the future direction of the corporation. While the son wants to take the maximum amount of profits out of the business each year for personal investments, the daughter wants to retain the profits in the corporation for expansion. PMF believe that the feud between the son and daughter will escalate when PMF are both deceased.

2. *Problem*

If PMF fail to either address or attempt to resolve the disagreement between their children, and if the children each receive one-half of the stock in Agrico Inc., then a deadlock will result.¹²⁶ If the children are unable to resolve their differences, then Agrico, Inc. may be judicially dissolved.¹²⁷ The dissolution may result in substantial income taxes from liquidation¹²⁸ and loss of productive time due to litigation demands.

3. *Potential Restructuring Solution*

Agrico Inc., can transfer approximately one-half of its assets to Newco, a subsidiary of Agrico Inc.¹²⁹ The shares of Newco can be distributed to PMF and the daughter in a tax free exchange for some of PMF's Agrico Inc., shares and all of the daughter's Agrico Inc., shares.¹³⁰ PMF and the son will then own all of Agrico Inc.'s shares. Upon their death, PMF's Agrico Inc., shares can be bequeathed to son and the Newco shares transferred to daughter. Thus, each child will control one-half of the farm operation and can determine the direction of the corporation he/she completely controls.

126. See *Sauer v. Moffitt*, 363 N.W.2d 269, 272 (Iowa Ct. App. 1984) and *Schildberg v. Schildberg*, 461 N.W.2d 186, 189 (Iowa 1990) which both discuss the disastrous effects of family disputes over how a corporation should be operated.

127. See MODEL BUS. CORP. ACT § 14.30 (1998).

128. See discussion *infra* Part II.B.2.

129. The transfer to Newco and the subsequent distribution of Newco shares will be tax-free if certain requirements are satisfied. See I.R.C. §§ 368(a)(1)(D), 355(a)(1) (1994 & Supp. III 1997).

130. See *id.*

D. *Common Fact Pattern III—Exploding Growth*

1. *Facts*

Agrico Inc., has diversified and experienced substantial growth in recent years. The company has developed a new process or is contemplating the purchase of a new business, or farm land, which it believes will generate substantial profits in the near future.

2. *Problem*

If the new process does, in fact, generate substantial profits and Agrico Inc., is a C corporation, then those profits may be subject to double taxation.¹³¹ Furthermore, the substantial profits, the growth in value of the farm land, or the new process could dramatically increase the value of Agrico Inc.'s stock and the potential estate taxes of PMF.¹³² Many entrepreneurs work to establish sizable estates only to see their wealth greatly reduced by estate taxes.¹³³

3. *Potential Restructuring Solution*

The children of PMF could form another organization to purchase the new process/farm land from Agrico Inc., or from a third party.¹³⁴ The purchase should obviously occur prior to the success of the new process or growth in farm land value since the purchase price must reflect the fair market value in order to avoid gift tax implications.¹³⁵ Furthermore, if the fair market value (purchase price) of the new process/farm land is in excess of the adjusted basis of the new process/farm land, then Agrico, Inc. will have gain to report.¹³⁶ The shift of income to another

131. See *infra* Part II.A.7.b.

132. See I.R.C. § 2001(c)(2) (1994 & Supp. III 1997) (designating the phase out of graduated rates and unified credit). See also I.R.C. § 2031(c) (1994 & Supp. III 1997) (designating the estate tax with respect to land subject to a qualified conservation easement). The Taxpayer Relief Act added § 2033A which allows an estate to exclude up to \$1,300,000 value of family-held businesses from the gross estate (the redesignated section of 2033A, now 2057, reduces the \$1,300,000 and allows a maximum deduction of \$675,000). See I.R.C. § 2033A(a) (Supp. III 1997) amended by Internal Revenue Reform Act of 1998, Pub. L. No. 105-206, § 6007(b)(1)(A), 1998 U.S.C.A.N. (112 Stat. 685) 807 (redesignating § 2033A to § 2057); I.R.C. § 2057(a)(2) (West Supp. 1999).

133. See Jeff Testerman, *Culverhouse Planned Divorce*, ST. PETERSBURG TIMES, Dec. 28, 1996, at 1B.

134. The children should consider the organization form of the new entity, with the likely choice of either a limited liability company or an S corporation.

135. See Treas. Reg. § 25.2512-1 (as amended in 1992); I.R.C. §§ 2501, 2503 (1994 & Supp. III 1997). If property is purchased below fair market value, then a gift may have occurred. See Treas. Reg. § 25.2512-1.

136. See I.R.C. § 1001(a) (1994).

organization or to children in a lower tax bracket and the shifting of potential growth to the children, should result in significant income and estate tax savings to PMF.

E. *Common Fact Pattern IV—Retirement—
Low Income Return from Agricultural Land*

1. *Facts*

Agrico Inc., the owner of farm land with a fair market value of \$1,000,000 and an adjusted basis of \$100,000, has been a C corporation since its inception and has substantial earnings and profits. PMF want to retire and need to generate more income from the corporation in order to realize their retirement goals.

2. *Problem*

If Agrico Inc., sells the farm land, the sale will generate large taxable gains¹³⁷ which would amount to substantial income taxes.¹³⁸ As a result, PMF will be unable to enjoy the sale proceeds without incurring a second level of income taxes on the gain if Agrico Inc., liquidates¹³⁹ or pays dividends.¹⁴⁰ If Agrico liquidates, the net funds available to PMF after double income taxes (one to Agrico, Inc., and again to its shareholders) will be approximately \$584,400.¹⁴¹

3. *Potential Restructuring Solution*

In lieu of selling the farm land, Agrico Inc., might consider an exchange of the farm for other real estate, such as an apartment or office building, which generates more income. The exchange could be tax free.¹⁴² If Agrico Inc., is a C corporation, after the like kind exchange, Agrico Inc., should consider making an S corporation election so that the income from the apartment or office building will be subject to taxation only at the shareholder level.¹⁴³

137. See I.R.C. § 1001(a) (1994).

138. See *id.* § 11(a).

139. See *id.* §§ 331(a), 1001(a).

140. See *id.* § 301(a)-(c).

141. Federal income taxes of \$272,000 to Agrico Inc., on a gain of \$800,000. The remaining \$728,000 is distributed to PMF and any gain (\$728,000 less \$10,000 adjusted basis) is taxed again. The new capital gains tax rate of twenty percent may apply. See I.R.C. § 1(h) (Supp. III 1997).

142. See I.R.C. § 1031(a) (1994). An exchange of real estate for real estate should qualify for tax-free treatment as long as Agrico Inc., held the farm land “for productive use in a trade or business or for investment” and holds the apartment or office building for a similar use, and as long as Agrico, Inc., receives no property which fails to qualify as like kind property or Agrico Inc., does not have a mortgage on the farm land it transfers. *Id.* § 1031(a)(1), (b), (d).

143. If the S corporation election is made, Agrico Inc., will obviously need to avoid the built-in gains tax and the excess passive investment income problems. See I.R.C. §§ 1374, 1375 (1994 & Supp. III 1997); I.R.C. § 1362(d)(3) (Supp. III 1997).

F. *Common Fact Pattern V—Donee Stock Sale*1. *Facts*

PMF have bequeathed or given their Agrico Inc., shares to their children. One of the children wants to sell his/her shares in Agrico Inc.

2. *Problem*

Neither Agrico Inc., nor the other shareholders have cash to purchase the selling child's shares. Additionally, the selling child desires to have any gain reported as capital gains.

3. *Potential Restructuring Solution*a. *Financing*

If the land has sufficient equity, then Agrico Inc., can borrow money with the farm land as collateral¹⁴⁴ and use the funds to purchase the child's shares. Alternatively, the child's shares could be purchased on an installment contract, with the purchase price being paid over a period of years.¹⁴⁵ Another possible financing method would be to purchase life insurance on Ma and/or Pa and use the life insurance proceeds to purchase the selling child's shares.¹⁴⁶

In lieu of Agrico Inc.'s purchasing the shares, the other shareholders could purchase the selling shareholder's shares utilizing one of the financing plans discussed in the preceding paragraph.

b. *Capital Gains*

The gain on the purchase of shares by Agrico Inc., will be capital gain only if the purchase qualifies as a redemption¹⁴⁷ for tax purposes. The selling shareholder would qualify for capital gain treatment if the redemption is either substantially disproportionate¹⁴⁸ or a complete termination¹⁴⁹ of the selling child's interest in the corporation. In either case, if the selling shareholder is related to the other

144. The borrowing of money against the farm land is not a taxable transaction. *See Woodsam & Ass'n v. Commissioner*, 198 F.2d 357, 359 (2nd Cir. 1952). The interest on the mortgage is deductible. *See* I.R.C. § 163(a) (1994).

145. In order for the child's gain to qualify for redemption and long-term capital gain treatment, the contract should be for less than fifteen years. *See Rev. Proc. 77-37*, 1977-2 C.B. 568.

146. The life insurance could be joint and survivor (proceeds paid only upon the death of the survivor). Such insurance usually results in lower insurance premiums.

147. *See* I.R.C. §§ 302(a), 1222 (1994).

148. *See id.* § 302(b)(2).

149. *See id.* § 302(b)(3).

shareholders, then under section 302(c)(1) and 318(a)(1), the remaining shares owned by the related shareholders will be attributed to the selling shareholder.¹⁵⁰ However, if the redemption is a complete termination of the selling shareholder's interest in the corporation, the family attribution rules may be waived, assuming the conditions for such waiver are satisfied.¹⁵¹

The purchase of the selling shareholder's shares by the other shareholders should qualify the selling child's gain from the sale as capital gains.¹⁵²

G. *Common Fact Pattern VI—
Thawing the Corporate Freeze*

1. *Facts*

PMF own sixty-five percent of Agrico Inc.'s stock and their children own the remaining thirty-five percent of the stock. When Agrico Inc., was initially incorporated, the company issued bonds (debentures) to PMF. Agrico Inc., is unable to make principal payments on the bonds.

2. *Problem*

Since Agrico Inc., is unable to pay the bonds' principal and interest, the bonds are a fixed and permanent liability on Agrico Inc.'s balance sheet. Creditors may be unwilling to lend money to Agrico Inc., with the bond liability on Agrico, Inc.'s books.

3. *Potential Restructuring Solution*

PMF could exchange their bonds for additional shares of Agrico Inc.'s common stock. The exchange should be tax-free as a recapitalization¹⁵³ if no stock is issued for accrued interest¹⁵⁴ and the fair market value of the stock equals the face amount of the bonds.¹⁵⁵

150. *Id.* §§ 302(c)(1), 318(a)(1).

151. *See id.* § 302(c)(2). After the sale of the selling child's shares, the selling child: must not be a shareholder, employee, director, or officer of Agrico Inc., (but can be a creditor); must not acquire such an interest within ten years except by inheritance or bequest; and must agree to contact the Secretary of the Treasury if such an interest is acquired within the ten-year period. *See id.* § 302(c)(2)(A). Additionally, the selling child must not have acquired the shares from or transferred other shares in the corporation to a related party within the ten-year period prior to the sale unless the acquisition or transfer "did not have as one of its principal purposes the avoidance of Federal income tax." *Id.* § 302(c)(2)(B).

152. *See id.* § 1222(3).

153. *See id.* § 368(a)(1)(E).

154. *See* I.R.C. § 354(a)(2)(B) (Supp. III 1997).

155. *See* I.R.C. § 108(e)(8) (1994).

H. *Common Fact Pattern VII—Corporate Conversion to Limited Liability Company or Limited Partnership*

1. *Facts*

PMF have recently been informed that the family operation should be a limited liability company or limited partnership instead of a corporation.

2. *Problem*

The merger or conversion of Agrico Inc., into a limited liability company or limited partnership could result in substantial gains to Agrico Inc., and its shareholders because the merger will be regarded as a liquidation of Agrico Inc.,¹⁵⁶ thus the possibly of a gain to both Agrico Inc.,¹⁵⁷ and its shareholders.¹⁵⁸

3. *Potential Restructuring Solutions*

PMF have several options, including the following:

- a. Electing S corporation status for Agrico Inc.¹⁵⁹
- b. Transferring Agrico Inc.'s assets to a limited liability company in exchange for an interest in the limited liability company.¹⁶⁰ PMF's children or grandchildren would transfer assets to the limited liability company in exchange for interests in the limited liability company.

Alternatively, a limited partnership could be formed with Agrico Inc., as the general partner and PMF's children or grandchildren as limited partners. However, the children or grandchildren would have to transfer assets to the limited partnership equal to the fair market value of the limited partnership interests received, if not, a gift would result.¹⁶¹

156. See Priv. Ltr. Rul. 95-43-017 (Oct. 27, 1995).

157. See I.R.C. §§ 336(a), 1001(a) (1994).

158. See *id.* §§ 331(a), 1001(a).

159. See *infra* Parts II.A.8.b., II.B. (discussing of the tax issues when converting from a C corporation to an S corporation).

160. Some state laws allow one person limited liability companies. See, e.g., IOWA CODE § 490A.102-13 (1999); MINN. STAT. ANN. § 322.11 (West 1995); NEB. REV. STAT. ANN. § 21-2605 (Michie 1995). One person limited liability companies will be regarded as a sole proprietorship for tax purposes, unless the limited liability company elects to be taxed as a corporation. See Treas. Reg. 301.7701-3(a) (as amended in 1998). The transfer of interests to the limited liability company should be tax free. See I.R.C. § 721(a) (1994). However, the transfer could result in gain recognition if the limited liability company is an investment company and securities diversification results, or Agrico is relieved of liabilities which exceed Agrico, Inc.'s adjusted basis. See *id.* §§ 721(b), 731(a), 752(b); Treas. Reg. § 1.351-1(c) (as amended in 1996).

161. See I.R.C. §§ 2501, 2503 (1994 & Supp. III 1997).

c. Forming a limited liability company or limited partnership to acquire new businesses.¹⁶²

Due to the difficulty of converting a C corporation into another entity,¹⁶³ the initial choice of entity for operating the agribusiness is extremely important. A limited liability company, limited partnership, or general partnership usually can be converted into another business structure with relatively few tax concerns.¹⁶⁴ However, if the initial business structure is a C corporation, then the ability to restructure is severely limited unless one or more of the tax-free reorganization provisions is applicable.¹⁶⁵

I. *Common Fact Pattern VIII—Sell Out*

1. *Facts*

Agrico Inc., a C corporation, has received an offer from Megabucks Inc., a large multinational corporation, to buy its assets for several million dollars.

2. *Problem*

If Megabucks Inc., buys Agrico Inc.'s assets for cash or an installment contract, Agrico Inc., will include the gain in its gross income and pay taxes on the gain.¹⁶⁶ In order for Agrico Inc.'s shareholders to receive the proceeds of the asset sale, Agrico Inc., will have to liquidate, therefore result in a gain for its shareholders.¹⁶⁷ The proceeds paid by Megabucks Inc., may be subject to a double

162. Income and growth will be shifted to the new entity; thus, reducing PMF's income and estate taxes if PMF's children and/or grandchildren are partners of the limited partnership or members of the limited liability company. Furthermore, PMF could be the operating manager of the limited liability company or general partner of the limited partnership if Ma and/or Pa want to control the new entity. The Internal Revenue Service may attempt to reallocate the income among the parents (Ma and Pa) and their children and grandchildren if PMF receive inadequate compensation for their services or capital. *See* I.R.C. § 704(e) (1994).

163. The problems include the potential for double taxation if the C corporation assets are sold or liquidated and the built-in gain tax and excess passive income concerns if the C corporation is converted to an S corporation. *See id.* §§ 331(a), 1001, 1374; I.R.C. § 1375 (1994 & Supp. III 1997).

164. *See* I.R.C. § 721(a) (1994) (recognizing no gain or loss in conversion to partnership); I.R.C. § 351(a) (1994) (recognizing no gain or loss in conversion to corporation); Rev. Rul. 84-111, 1984-2 C.B. 88 (describing three avenues for incorporating a partnership, each with different tax results).

165. For a discussion of the reorganization alternatives, see MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS ACQUISITIONS AND LEVERAGED BUYOUTS* ¶ 601 (1994) and BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 12.01-67 (6th ed. 1998).

166. *See* I.R.C. §§ 453, 1001(a) (1994).

167. *See id.* §§ 331(a), 1001(a).

level of taxation—one level to the corporation and a second level to Agrico Inc.'s shareholders.¹⁶⁸

3. *Potential Restructuring Solution*

a. *Introduction*

If Megabucks Inc., is willing to substitute its stock for cash, and if Agrico Inc., and its shareholders are willing to accept Megabucks Inc., shares, then the acquisition may be structured as a tax-free reorganization through any of the following: merger;¹⁶⁹ stock for stock;¹⁷⁰ stock for assets;¹⁷¹ reverse triangular merger;¹⁷² or forward triangular merger.¹⁷³

b. *Merger*

Agrico Inc., could merge into Megabucks Inc., for Megabucks stock or Megabucks stock and cash.¹⁷⁴ Agrico Inc.'s shareholders would receive the stock, or stock and cash, and Agrico Inc., would cease to exist.¹⁷⁵ Megabucks would assume Agrico's liabilities, obligations, and assets by operation of law.¹⁷⁶ If Megabucks wants to reduce its exposure to Agrico's liabilities, Megabucks could form a subsidiary and have Agrico merge into the subsidiary (forward triangular merger)¹⁷⁷ or have the subsidiary merge into Agrico (reverse triangular merger).¹⁷⁸

168. *See id.* §§ 331(a), 336(a), 453, 1001(a). The net proceeds to Agrico Inc.'s shareholders could be less than seventy percent of the gross sale proceeds received by Agrico Inc. *See* I.R.C. § 1(h) (Supp. III 1997); I.R.C. § 11(b) (1994).

169. *See* I.R.C. §§ 361(a), 368(a)(1)(A) (1994).

170. *See* I.R.C. §§ 361(a), 368(a)(1)(B) (1994).

171. *See* I.R.C. §§ 361(a), 368(a)(1)(C) (1994).

172. *See* I.R.C. §§ 361(a), 368(a)(2)(E) (1994).

173. *See* I.R.C. §§ 361(a), 368(a)(2)(D) (1994).

174. *See* MODEL BUS. CORP. ACT § 11.01 (1998). The merger will be tax free to Agrico Inc. and its shareholders if no cash is received by the shareholders and the merger qualifies as a tax free reorganization. *See* I.R.C. § 354 (1994 & Supp. III 1997); I.R.C. § 368(a) (1994). If cash is received by the shareholders, then some gain or a dividend may be recognized. *See* I.R.C. § 356(a)-(b) (1994). In order for the transaction to be treated as a merger for tax purposes, the cash received by Agrico, Inc.'s shareholders should not exceed 50% of the total consideration (stock and cash) received. *See* Rev. Proc. 77-37, 1977-2 C.B. 569.

175. *See* MODEL BUS. CORP. ACT § 11.06.

176. *See id.*

177. *See* I.R.C. § 368(a)(2)(D) (1994) (regarding the tax requirements of a forward triangular merger).

178. *See id.* § 368(a)(2)(E) (regarding the tax requirements of a reverse triangular merger).

c. *Stock for Assets*

Megabucks would exchange its stock for substantially all of the assets of Agrico.¹⁷⁹ Agrico would distribute to its shareholders the shares of Megabucks and then Agrico would liquidate.¹⁸⁰ Alternatively, Megabucks could form a subsidiary and have Agrico transfer its assets to the subsidiary in exchange for Megabucks shares.¹⁸¹

d. *Stock for Stock*

Megabucks must use only its voting stock (or the voting stock of its controlling parent corporation) to acquire both control of Agrico and Agrico shares from Agrico's shareholders.¹⁸² If Megabucks issues stock and cash to Agrico's shareholders in exchange for their Agrico shares, then the transaction will not qualify as a tax-free reorganization.¹⁸³

e. *Stock for Cash*

An alternative to the asset sale is a stock sale for cash (or notes) by Agrico Inc.'s shareholders. Most buyers want to purchase assets in order to avoid liabilities of the seller and to obtain a cost basis in the assets.¹⁸⁴ However, if the buyer can be persuaded to purchase the stock, then the gain to the shareholders may be taxed only at a twenty percent rate.¹⁸⁵ A buyer may be persuaded to purchase the Agrico stock if Agrico Inc.'s shareholders assure the buyer that Agrico Inc., has no tort, contract, and/or other liability exposure, and either the purchase price is reduced to account for the built-in tax liability or the buyer contemplates holding the farm land for the foreseeable future.¹⁸⁶ In the case of a stock sale, the buyer may want personal

179. See MODEL BUS. CORP. ACT § 12.02. The stock for assets will be tax free if the tax-free incorporation rules of § 351 are satisfied, or if the stock is to be distributed in a reorganization. See I.R.C. §§ 361(a), 368(a)(1)(C) (1994); I.R.C. § 351 (1994 & Supp. III 1997). See also Rev. Proc. 77-37, 1977-2 C.B. 570; I.R.C. § 368(a)(2)(B) (1994) (stating some of the requirements of an I.R.C. § 368(a)(1)(C) reorganization).

180. See MODEL BUS. CORP. ACT § 6.40. The distribution of stock to Agrico Inc.'s shareholders is tax free, provided the reorganization requirements are satisfied. See also I.R.C. § 354(a)(1) (1994); I.R.C. § 356 (1994 & Supp. III 1997); I.R.C. § 368(a)(1)(C), (2)(G) (1994) (requiring Agrico, Inc. to liquidate to satisfy the requirements of a C reorganization).

181. See I.R.C. § 368(a)(1)(D) (1994). Additionally, the acquiring corporation can acquire Agrico's assets and transfer the assets into a subsidiary which is controlled by the acquiring corporation. See *id.* § 368(a)(2)(C).

182. See MODEL BUS. CORP. ACT § 11.02; I.R.C. § 368(a)(1)(B) (1994).

183. See I.R.C. § 368(a)(1)(B) (1994); Clark v. Commissioner, 86 T.C. 138, 142-43 (1986).

184. See I.R.C. §§ 1011, 1012 (1994).

185. See I.R.C. § 1(h) (Supp. III 1997).

186. In which case Agrico Inc., could elect S corporation status. I.R.C. § 1361(a) (1994).

guarantees and indemnity and/or hold-harmless agreements from Agrico, Inc. shareholders, and/or some of the sale proceeds held in an escrow account.

J. *Common Fact Pattern IX—Insolvent S Corporation—
Foreclosure or Sale of Assets*

1. *Facts*

Agrico Inc., an S corporation, is in the process of selling its assets in order to avoid a foreclosure action by one or more of its creditors. The shareholders of Agrico Inc., will receive no assets from the sale or liquidation of Agrico Inc.'s assets.

2. *Problem*

The gain from Agrico's sale of its assets will flow through to Agrico's shareholders and increase their gross income and adjusted basis in the shareholders' stock,¹⁸⁷ even though the shareholders receive none of the proceeds. Thus, the shareholders have no assets from the sale with which to pay the additional income taxes generated by the Agrico sale.

3. *Potential Restructuring Solution*

Before the sale or foreclosure is finalized, Agrico should revoke its S corporation election¹⁸⁸ or terminate the election by disqualifying itself as an S corporation.¹⁸⁹ Once the election is revoked or terminated, Agrico can elect to have normal accounting rules apply so that all gain from the sale or foreclosure is allocated to the C corporation, rather than the S corporation return.¹⁹⁰ Thus, the gain and tax on the gain will be trapped inside the C corporation.¹⁹¹ The gain will not be subject to inclusion in Agrico's shareholders gross income; therefore, no income taxes will be collected from Agrico's shareholders.¹⁹²

187. *See id.* § 1363(a); I.R.C. §§ 1366(a), 1367(a) (1994 & Supp. III 1997).

188. *See id.* § 1362(d)(1).

189. *See id.* §§ 1362(d)(2), 1363(d)(3).

190. *See id.* § 1362(e)(3).

191. *See id.* §§ 61, 1001; I.R.C. § 63 (1994 & Supp. III 1997).

192. The Internal Revenue Service may attempt to pierce the corporate veil. *See In re Parton*, 137 B.R. 902, 905 (Bankr. S.D. Ohio 1991); *In re Carlson*, 390 N.W.2d 780, 784 (Minn. Ct. App. 1986); *Briggs Transp. Co. v. Starr Sales Co.*, 262 N.W.2d 805, 810 (Iowa 1978). Additionally, the Internal Revenue Service may pursue the shareholders if unlawful distributions to shareholders were made, or use transferee liability provisions to collect Agrico Inc.'s tax liability from its shareholders. *See* MODEL BUS. CORP. ACT §§ 6.40, 8.33(b)(2) (1998); I.R.C. § 6901 (1994 & Supp. III 1997).

K. *Common Fact Pattern X—
Repayment of S Corporation Debt*

1. *Facts*

Agrico Inc., an S corporation, owes substantial funds to secured creditors. These creditors will be paid in full over a ten year period.

2. *Problem*

Except for interest payments, Agrico's repayment of its creditors will generate no deduction for Agrico.¹⁹³ Thus, the repayment of principal from Agrico's income will not decrease the income passed through to Agrico's shareholders.¹⁹⁴ Additionally, after using its income to pay creditors, Agrico will have no funds to distribute to its shareholders for their use in paying income taxes attributable to the nondeductible creditor payments.

3. *Potential Restructuring Solution*

Agrico should revoke or terminate its S corporation election.¹⁹⁵ As a result, Agrico, as a C corporation, would then pay income taxes on the principal repayments at its corporate tax rate. This rate may be substantially lower than the marginal tax rate of its shareholders,¹⁹⁶ who would, thus, avoid being taxed on the principal repayments. The income tax savings to Agrico and its shareholders would equal the difference in tax brackets. For example, if Agrico is in the fifteen percent bracket and its shareholders are in the thirty-six percent tax bracket, the tax savings will be twenty-one percent multiplied by the nondeductible principal repayments.¹⁹⁷

Agrico can reelect S corporation status after its creditors have been repaid. However, the company must wait five years after terminating the S election before reelecting S corporation status, unless Agrico receives the permission of the Secretary of the Treasury to reelect S corporation status before the end of the five year period.¹⁹⁸

193. Unless Agrico is a cash basis taxpayer and the payments to creditors are ordinary and necessary business expenses, principal payments are not deductible. *See* I.R.C. § 162(a) (1994 & Supp. III 1997). Interest payments may be deductible if Agrico Inc. is a cash basis taxpayer. *See* I.R.C. § 163(a) (1994).

194. *See* I.R.C. § 1363(a)-(b) (1994); I.R.C. § 1366(a) (1994 & Supp. III 1997). The payments may be deductible if the amount paid was for ordinary and necessary business expenses and Agrico is a cash basis taxpayer. I.R.C. §§ 162, 461 (1994 & Supp. III 1997).

195. *See* I.R.C. § 1362(d) (1994 & Supp. III 1997).

196. If Agrico Inc.'s taxable income does not exceed \$50,000, then the marginal corporate tax rate will be fifteen percent. *See* I.R.C. § 11(b)(1)(A) (1994).

197. *See id.* §§ 1(a)-(d), 11(b).

198. *See id.* § 1362(g).

L. *Common Fact Pattern XI— Multiple Goals— Multiple Entities*

1. *Facts*

Agrico Inc., a C corporation, is rapidly expanding. Its shareholders and employees have established the following goals:

- a. Reduce social security and/or self-employment tax paid by Agrico's employees and contractors.
- b. Spread the income to lower-bracket taxpayers.
- c. Reduce the growth of Agrico and shift the growth to younger generation family members.
- d. Avoid double taxation upon the sale of the business.
- e. Provide tax-free benefits to employees/shareholders.
- f. Take advantage of the fifteen percent graduated tax bracket allowed on a corporation's first \$50,000 of taxable income.¹⁹⁹

2. *Problem*

No one organizational structure will satisfy all of the goals set by Agrico's shareholders and directors. For example, an S corporation structure may reduce social security tax,²⁰⁰ spread the income to lower-bracket taxpayers²⁰¹ and reduce the growth of Agrico shares owned by the older generation.²⁰² However, employees/shareholders of an S corporation do not receive tax-free benefits²⁰³ and

199. *See id.* § 11(b).

200. Distributions to S corporation shareholders under present law are not subject to social security tax, Medicare tax, or self-employment tax. *See id.* §§ 3101, 3121, 1401, 1402; Rev. Rul. 73-361, 1973-2 C.B. 331. The Internal Revenue Service may argue that the employee/shareholder has unreasonably low compensation and attempt to reclassify distributions as compensation, thus subjecting the increased compensation to social security and Medicare taxes. *See Rev. Rul. 74-44, 1974-1 C.B. 287.*

201. Shareholder includes his/her pro rata share of S corporation's income, deduction, gains, losses and credits. *See I.R.C.* § 1366(a)(1) (1994 & Supp. III 1997). However, if a family group is included as shareholders of a corporation and if the corporation fails to pay reasonable compensation for services rendered or for capital furnished to Agrico, Inc., the Internal Revenue Service may reallocate items to properly compensate the service or capital provider. *See I.R.C.* § 1366(e) (1994).

202. *See I.R.C.* § 2031 (1994 & Supp. III 1997); *I.R.C.* § 2033 (1994); *I.R.C.* § 2033A (Supp. III 1997) *amended by* Internal Revenue Reform Act of 1998, Pub. L. No. 105-206, § 6007(b)(1)(A), 1998 U.S.C.C.A.N. (112 Stat. 685) 807 (redesignating § 2033A to § 2057).

203. *See I.R.C.* §§ 79(a), 105, 1372(a) (1994); *I.R.C.* §§ 106, 119, 125, 132 (1994 & Supp. III 1997).

the S corporation cannot take advantage of the graduated tax brackets.²⁰⁴ On the other hand, a C corporation structure may satisfy the goal of tax-free benefits for employees/shareholders²⁰⁵ and permit use of the fifteen percent graduated tax bracket,²⁰⁶ but fail to satisfy the other goals.²⁰⁷ Finally, the various forms of partnerships and limited liability corporations may allow achievement of the first four goals²⁰⁸ but fail to provide for meeting the last two.²⁰⁹

3. *Potential Restructuring Solution*

In order to achieve all of the goals, a multi-entity structure should be considered—for example:

- a. The real estate could be owned by a limited partnership or limited liability company and leased to the manufacturing or farming entity.²¹⁰
- b. The manufacturing or farming entity could be a C corporation and its taxable income would be reduced by rent payments²¹¹ to the limited partnership or limited liability company. Additionally, the C corporation could provide its employees/shareholders with tax-free fringe benefits.²¹²

204. See I.R.C. §§ 11(b), 1363(a) (1994).

205. See I.R.C. §§ 79(a), 105 (1994); I.R.C. §§ 106, 119, 125, 132 (1994 & Supp. III 1997).

206. See I.R.C. § 11(b) (1994).

207. Compensation paid by a C corporation is subject to social security and Medicare taxes. See *id.* § 310; I.R.C. § 3121 (1994 & Supp. III 1997). Dividend distributions by a C corporation to the extent of the corporation's earnings and profits may be subject to taxation at the shareholder level. See I.R.C. §§ 61(a)(7), 301, 316 (1994). The C corporation may have already paid income tax on its taxable income prior to the distribution of dividends. See I.R.C. § 11(a)-(b) (1994).

208. See *infra* Parts II.A.4-7. General partnerships usually do not avoid self-employment taxes. See I.R.C. §§ 1401, 1402(b) (1994).

209. Since partnerships are pass-through entities, the partnership type entity pays no income taxes and generally provides no tax free benefits to its partners; because usually, the partners are not employees. See I.R.C. § 701 (1994). See *generally* I.R.C. §§ 79(a), 105 (1994); I.R.C. §§ 106, 119, 125, 132 (1994 & Supp. III 1997) (discussing benefits provided to employees).

210. The rental income will pass through to the partner or member. See I.R.C. §§ 701-703 (1994). The rental income should not be subject to self-employment tax, except to the general partner or operating member in charge of operations. See *id.* § 1401; I.R.C. § 1402 (1994 & Supp. III 1997). The Internal Revenue Service has taken the unduly restrictive position that if land is rented to a partnership or corporation and the land owner is an active partner or corporate officer or employee, those rental payments are subject to self-employment tax. See *Mizell v. Commissioner*, 70 T.C.M. (CCH) 1469, 1472 (1995). The *Mizell* Court and the Internal Revenue Service's position are inconsistent with the language of section 1402(a)(1) which requires an arrangement between the landowner and another individual. See *id.* at 1472; I.R.C. § 1402(a)(1) (1994). Obviously, a partnership or corporation is *not* another individual. See I.R.C. § 1402(a)(1) (1994).

211. See *id.* § 162(a)(3).

212. See *id.* §§ 79(a), 105; I.R.C. §§ 106, 119, 125, 132 (Supp. III 1997).

c. The sales would be handled by an S corporation. The income would flow through the S corporation to its shareholders²¹³ and the distributions to the shareholders would be included in the shareholders' gross income, but only to the extent that the distributions exceed the shareholders' bases in their shares.²¹⁴ Additionally, if the S corporation were sold, any gain would be reported at the S corporation level²¹⁵ and would flow through to the S corporation shareholders,²¹⁶ thus being subject to potential income taxation at the shareholder level only, but not subject to income taxation at the corporate level.²¹⁷

III. CONCLUSION

The evaluation of a business entity's format should be performed on a continual basis due to constantly changing factual circumstances, federal tax law and state laws. Although selection of a business entity's initial form of organization is extremely important and will influence future restructuring options, the format should be periodically reviewed by the entity, its owners, and tax and legal advisors.

As demonstrated by the hypothetical cases presented herein, the structuring and restructuring options available to any client are determined by the goals of the client, as well as legal and tax parameters. Tax, financial, and legal planners should stress flexibility in business organization formation to allow for the reorganization of the entity's structure in order to conform to ever-changing state and federal laws, as well as changing client goals, assets, and relationships.

213. See I.R.C. § 1366(a) (Supp. III 1997).

214. See I.R.C. § 1368(a)-(c) (1994).

215. See *id.* § 1363(b); I.R.S. Form 1120S.

216. See I.R.C. § 1366(a) (Supp. III 1997). The character of the gain also passes through to the shareholders. See I.R.C. § 1366(b) (1994).

217. A taxpayer should consider a multi-entity structure only if the taxpayer is willing to recognize the entities as separate entities for accounting and other purposes, and be willing to accept additional complexity. Some taxpayers will disregard the separate entities and operate from a single bank account. These taxpayers should not use multi-entity structures.

EXHIBIT 1

TAX PROS AND CONS OF PARTNERSHIPS, LIMITED
LIABILITY CORPORATIONS, AND S AND C CORPORATIONS.

| | S Corporation²¹⁸ | Regular (C) Corporation | Tax Partnership Entities²¹⁹ |
|---|--|---|--|
| 1. Personal liability of limited investors. | None, unless pierce the corporate veil. ²²⁰ | None, unless pierce the corporate veil. ²²¹ | Unlimited for general partners. ²²² except limited partners have less exposure. ²²³ LLCs and LLPs have limited liability for members or partners. ²²⁴ |
| 2. Graduated tax bracket. | None, income passes through. ²²⁵ | Yes, unless taxable income exceeds \$100,000 then graduated brackets are phased out. ²²⁶ However, if it is a personal service corporation, then all taxable income is subject to 35% rate. ²²⁷ | None, income passes through. ²²⁸ |
| 3. Losses pass through. | Yes, shareholder can use to the extent of adjusted basis in shares and corporate notes. ²²⁹ | No, shareholder is not entitled to use corporate losses. | Yes to the extent of the adjusted basis in partnership interest. ²³⁰ |
| 4. Fringe benefits. | 2% shareholder treated as a partner; thus, few fringe benefits. ²³¹ | Employees can exclude fringe benefits subject to some discrimination rules: a. group term life insurance; ²³² b. medical insurance premiums; ²³³ c. disability premiums; ²³⁴ d. meals and lodging; ²³⁵ e. cafeteria plans; ²³⁶ and f. other fringes. ²³⁷ | Few fringe benefits are allowed tax free to a partner or member because she is not an employee. |
| 5. Social Security. | Compensation subject to Social Security tax; ²³⁸ however, can reduce compensation and issue more dividends, which are not subject to Social Security tax. Same tax effect to shareholders. ²³⁹ | Compensation up to \$72,600 subject to Social Security tax. ²⁴⁰ If paying dividends, which are not subject to Social Security tax, in place of compensation, then the corporation receives no deduction. ²⁴¹ | General partners - income subject to self employment tax up to \$72,600. ²⁴² |

EXHIBIT 1 CONTINUED
TAX PROS AND CONS OF PARTNERSHIPS, LIMITED
LIABILITY CORPORATIONS, AND S AND C CORPORATIONS.

| | | | |
|---|--|--|---|
| 6. Taxable year. | Generally, calendar year, unless establish a business purpose for a different taxable year. ²⁴³ Additionally, an S corporation can have a 9/30 - 10/31 or a 11/30 year end if criteria is satisfied. ²⁴⁴ | Fiscal year or calendar year. ²⁴⁵ A personal service corporation is required to use a calendar taxable year unless can satisfy criteria for 9/30, 10/31, or 11/30. ²⁴⁶ | Generally, calendar year, unless establish a business purpose for a different taxable year. ²⁴⁷ Additionally, a partnership can have a 9/30 - 10/31 or a 11/30 year end if criteria is satisfied. ²⁴⁸ |
| 7. Method of Accounting. | Cash or Accrual. | Cash or Accrual. ²⁴⁹ | Cash or Accrual. |
| 8. Accumulated Earnings Tax. | None. | Possibility if earnings are allowed to accumulate beyond reasonable needs. ²⁵⁰ | None. |
| 9. Personal Holding Company Tax. | None. | Yes, if meets qualifications. ²⁵¹ | None. |
| 10. Liquidation. | Gains on appreciated assets pass through to shareholders. ²⁵² Built-in gain rules could apply if corporation was a C corporation and elected S status within ten years of disposition of assets. ²⁵³ | Gain on appreciated property is reported at corporate level. ²⁵⁴ Shareholders may also report a gain upon liquidation. ²⁵⁵ | No gain to partnership upon liquidation and generally no gain to partners or members unless cash distributed exceeds adjusted basis in partnership. ²⁵⁶ |
| 11. Subject to Corporate Alternative Minimum Tax Rules. | No. | Yes, need to monitor life insurance proceeds paid to corporation. ²⁵⁷ | No. |
| 12. Double Tax. | None unless built-in gain tax or excess passive investment income. ²⁵⁸ | Yes, on taxable income but can reduce by payment of salary, rent, etc. ²⁵⁹ | No. |
| 13. Inclusion of Entity Debt in Basis. | No. | No. | Yes. ²⁶⁰ |
| 14. Distributions of Property. | May cause recognition of gain to corporation and to the shareholder. ²⁶¹ | May cause recognition of gain to corporation and to the shareholder. ²⁶² | Generally no recognition of gain to partner. ²⁶³ |
| 15. Formation. | Need to meet controlled corporation rules; liability in excess of basis possible. ²⁶⁴ | Need to meet controlled corporation rules; liability in excess of basis possible. ²⁶⁵ | Usually tax free. ²⁶⁶ |

EXHIBIT 1 CONTINUED
TAX PROS AND CONS OF PARTNERSHIPS, LIMITED
LIABILITY CORPORATIONS, AND S AND C CORPORATIONS.

| | | | |
|--|---|---|---|
| 16. Special allocation of income, losses, etc. | Not allowed (allocated based upon shared ownership). ²⁶⁷ | Not allowed. | Permitted if substantial economic effect. ²⁶⁸ |
| 17. Ownership interests. | Single class of stock, but can have voting differences. ²⁶⁹ | Unlimited. | Unlimited. |
| 18. Death of shareholder or partner. | No basis step up for entity (inside basis). However, beneficiaries of stock will receive a stepped up basis. ²⁷⁰ | No basis step up for entity (inside basis). However, beneficiaries of stock will receive a stepped up basis. ²⁷¹ | Basis increase to partnership if election is made. ²⁷² |

218. Small business corporation which elects to be taxed as an S corporation. *See* I.R.C. § 1361(a) (1994); I.R.C. § 1361(b) (Supp. III 1997).

219. *See generally* LIMITED LIABILITY COMPANIES, *supra* note 46 (discussing limited liability companies); *Tax Classification of LLC's*, Limited Liability Company Guide (CCH) ¶ 4010-4100, at 1101-1145 (Feb. 1997) (discussing limited liability companies); John C. Ale, *Substantive Partnership Law: Special Problems of General and Limited Partnerships*, 1 PARTNERSHIPS, LLCs, AND LLPS: UNIFORM ACTS, TAXATION, DRAFTING, SECURITIES, AND BANKRUPTCY 5, 5-106 (12th ed. 1996) (discussing partnerships, limited liability partnerships, and limited liability companies); BROMBERG & RIBSTEIN, *supra* note 3 (discussing limited liability partnerships).

220. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1061 (1991).

221. *See id.*

222. *See* Ale, *supra* note 219, at 20-23.

223. *See id.* at 74-78.

224. *See* Stuart Levine, *Limited Liability Companies, Limited Liability Partnerships, Limited Liability limited Partnerships, and Other Novel Entities*, 1 PARTNERSHIPS, LLCs AND LLPS: UNIFORM ACTS, TAXATION, DRAFTING, SECURITIES, AND BANKRUPTCY, 523 (12th ed. 1996).

225. *See* I.R.C. § 1363 (1994); I.R.C. § 1366 (1994 & Supp. III 1997).

226. *See* I.R.C. § 11(b) (1994).

227. *See id.*

228. *See* I.R.C. §§ 701, 702 (1994 & Supp. III 1997).

229. *See* I.R.C. § 1366(d)(1) (Supp. III 1997).

230. *See* I.R.C. § 704(d) (1994).

231. *See* I.R.C. § 1372(a)(2) (1994).

232. *See id.* § 79(a).

233. *See* I.R.C. § 106(a) (Supp. III 1997).

234. *See* I.R.C. § 104(a)(3) (1994); I.R.C. § 106 (Supp. III 1997).

235. *See* I.R.C. § 119 (1994 & Supp. III 1997).

236. *See id.* § 125.

237. *See id.* § 132.

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238. See I.R.C. § 24 (d)(5)(A) (Supp. III 1997) (under this section, Social Security taxes are defined as tax imposed by I.R.C. §§ 3101, 3201(a), 1401 3211(a)(1). These sections impose taxes upon wages and compensation but make no mention of dividends.).
239. See *id.*
240. See U.S. MASTER TAX GUIDE (CCH) ¶ 49, at 49 (1999). Social security tax is 12.4% of \$72,600. See I.R.C. §§ 1401(a), 3101, 3102 (1994). All earned income is subject to an additional 2.9% Medicare tax. See I.R.C. §§ 1401(b), 3101 (1994). The amount of earned income subject to the social security tax increases each year with inflation. See I.R.C. § 3101(c) (1994).
241. See I.R.C. § 24 (b)(5)(A) (Supp. III 1997) (under this section, Social Security taxes are defined as tax imposed by I.R.C. §§ 3101, 3201(a), 1401 3211(a)(1). These sections impose taxes upon wages and compensation but make no mention of dividends.).
242. See U.S. MASTER TAX GUIDE, *supra* note 242, ¶ 47, at 49. All self-employment income is subject to an additional 2.9% Medicare tax. See I.R.C. § 1401(b) (1994). Self-employed taxpayers receive a 50% deduction for self-employment and Medicare taxes. See I.R.C. § 164(f) (1994). Self-employment tax is 12.4% of \$72,600 and the Medicare tax is 2.9% of all self-employment income. See I.R.C. § 1401 (1994); I.R.C. § 1402 (1994 & Supp. III 1997) The amount of self-employment income subject to the self-employment tax increases each year with inflation. See I.R.C. § 3101(b) (1994).
243. See I.R.C. § 1378 (1994).
244. See *id.* § 444.
245. See *id.* § 441(b)(1).
246. See *id.* §§ 441(i), 444.
247. See *id.* § 706(b).
248. See *id.* § 444.
249. For the limitation on methods of accounting for corporations engaged in farming and the use of the cash method of accounting, see I.R.C. § 447 (1994 & Supp. III 1997), and I.R.C. § 448 (1994).
250. See I.R.C. §§ 531, 533, 534, 535, 536 (1994); I.R.C. §§ 532, 537 (1994 & Supp. III 1997).
251. See I.R.C. §§ 541, 544, 545, 546, 547 (1994); I.R.C. §§ 542, 543 (1994 & Supp. III 1997).
252. See I.R.C. §§ 336, 1363 (1994); I.R.C. § 1366 (1994 & Supp. III 1997).
253. See I.R.C. §§ 331, 336, 1001, 1363(d) (1994); I.R.C. § 1374 (1994 & Supp. III 1997).
254. See I.R.C. §§ 336, 1001 (1994).
255. See *id.* §§ 331, 336, 1001.
256. See I.R.C. §§ 731, 732 (1994 & Supp. III 1997).
257. See *id.* §§ 55, 56, 57.
258. See I.R.C. §§ 1374, 1375 (1994 & Supp. III 1997).
259. Payment of deductible items to shareholder, employee, or investor will avoid double tax. See I.R.C. §§ 162, 163, 164 (1994 & Supp. III 1997).
260. See IRC § 752 (1994).
261. See IRC §§ 331, 336, 1363 (1994); I.R.C. § 1366 (1994 & Supp. III 1997)
262. See IRC §§ 331, 336 (1994).
263. See IRC § 731 (1994 & Supp. III 1997).
264. See IRC § 351 (1994 & Supp. III 1997); I.R.C. §§ 357, 1032 (1994).
265. See IRC § 351 (1994 & Supp. III 1997); I.R.C. §§ 357, 1032 (1994).
266. See IRC § 721 (1994 & Supp. III 1997); I.R.C. § 756 (1994).
267. See IRC § 1366, 1377 (1994 & Supp. III 1997).
268. See *id.* § 704.

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269. *See* IRC § 1361(b)(1)(D)-(c)(4) (1994).
270. *See* I.R.C. § 1014 (1994 & Supp. III 1997).
271. *See* I.R.C. § 1014 (1994 & Supp. III 1997).
272. *See* IRC §§ 743, 754, 755 (1994).