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A COMPARISON OF THE PARTNERSHIP STRUCTURE AND THE S CORPORATION FOR OWNING AND OPERATING REAL ESTATE*

Peter M. Fass**

INTRODUCTION

The Tax Reform Act of 1986¹ (the Act) is the most extensive revision of the Federal tax laws since the enactment of the Internal Revenue Code of 1954.² The tax considerations for structuring every real estate transaction are drastically changed by several of the provisions of the Act, regardless of whether the transaction is structured in partnership or S corporation³ form. This article compares the partnership and S corporation for owning and operating real estate.

I. ELECTING S CORPORATION STATUS

The first determination to be made in considering whether to elect S corporation status is whether a particular corporation is eligible to make the election. An S corporation is "a small business corporation for which an election under Code section 1362(a) is in effect for such year."⁴ In order to be a "small business corporation," a corporation must have (1) no more than 35 shareholders; (2) shareholders which are either (a) an individual, (b) an estate or (c) cer-

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* This article does not consider any provisions of the Technical Revenue Act of 1988 or the second installment of the Passive Loss Regulations issued on May 11, 1989 concerning the definition of "activity".
tain trusts; (3) no non-resident alien as a shareholder; and (4) no more than one class of stock. In addition, the corporation must be a domestic "eligible corporation."  

The above restrictions should be compared with the flexibility of the partnership format. A partnership can have as little as two partners or as many as ten thousand. There are no restrictions on the number or makeup of the partners — a partner can be an individual, corporation (whether a C corporation, S corporation or personal service corporation), trust, estate, tax-exempt entity or partnership.

A general partnership or joint venture is the ownership of a project by more than one investor as a business venture to obtain joint profit. Each general partner or joint venturer (hereinafter general partner) is a co-owner of the project and shares in the project’s profits and losses on a pro-rata basis. Under the law of partnerships, unless the general partners agree otherwise, all members of a general partnership have equal rights in the management and operation of the partnership business. Since each partner is an agent of the partnership, such party can bind the entity to any act within the

6. The Proposed Treasury Regulations define an "ineligible corporation" as a corporation that is (1) a member of an affiliated group (determined under I.R.C. § 1504 without regard to any exception contained in subsection (b) thereof), whether or not that affiliated group has ever filed a consolidated return; (2) a financial institution to which I.R.C. §§ 585 or 593 applies, whether or not that financial institution uses the "reserve from bad debts" method provided in I.R.C. § 166(c), (3) an insurance company subject to tax under Subchapter L, Chapter 1 of the Code; (4) a corporation to which an election under I.R.C. § 936 (concerning Puerto Rico and possession tax credits) applies; or (5) a domestic international sales corporation (DISC) or former DISC. There are certain exemptions provided in the Proposed Treasury Regulations regarding qualified insurance corporations. See Prop. Treas. Reg. § 1.1361-1A(c), 51 Fed. Reg. 35,659 (1986).
7. A partnership is defined by section 6 of the Uniform Partnership Act as "an association of two or more persons to carry on as co-owners a business for profit." Section 2 of the Uniform Partnership Act defines "person" to include "individuals, partnerships, corporations and other associations." UNIFORM LIMITED PARTNERSHIP ACT, §§ 6, 2 [hereinafter UPA].
8. For example, several of the master limited partnerships listed on the New York Stock Exchange have many more than ten thousand investors.
9. See supra note 7.
10. A joint venture is a general or limited partnership formed for a specific limited purpose. The term "joint venture" essentially is used to remove the apparent authority of one general partner to bind his co-adventurers with respect to business dealings which are related to the purpose of the joint venture. In other words, the connotation of being a "joint venturer" means that the participants are only partners with respect to the single project for which the venture was formed.
12. UPA, supra note 7, § 18(e).
scope of the partnership's business,\(^\text{13}\) effectively binding all other partners to the consequences of the act.\(^\text{14}\) Of course, the agreement may limit the authority of the parties to bind the other parties, but third parties may not be bound by the limits on the authority unless they have notice of the limitations placed on the acting party's authority. Thus, management and control may be a problem in a general partnership or joint venture. For the partners' protection, indemnity provisions are included in the partnership agreement or joint venture agreement against acting beyond the scope of authority defined in the agreement.

A general partnership or joint venture exposes each general partner to unlimited liability.\(^\text{16}\) Each individual partner can be held fully liable for any and all obligation of the partnership including contract claims, tort claims (e.g., personal injury claims) and the like. A general partnership or joint venture ceases to exist on a partner's death, bankruptcy or withdrawal;\(^\text{16}\) however, the parties can agree by contract to continue the entity in the event of a termination.\(^\text{16}\) As a result of the exposure to unlimited liability and the operational problems that are associated with general partnerships (agency agreements or managing agreements to centralize control), both investors and syndicators are reluctant to use the general partnership as the form for a real estate syndication entity even though it does permit pass-through to investors of the tax benefits of the investments.

Corporate-type entities have the advantages of centralized management, ease of transferability of interests in the syndication and limited liability for the investor, but have the disadvantage of double taxation. The general partnership has the advantage of pass-through of tax benefits but the disadvantages of unlimited investor liability, lack of centralization of management control (without awkward and often complex management agreements) and lack of marketing acceptance by investors and their advisors. The limited partnership vehicle, however, has all the advantages of each of the foregoing entities without any of the disadvantages except, perhaps, the lack of free transferability of interest.

In a nutshell, real estate investments are most frequently organ-

\(^{13}\) Id. § 9.
\(^{14}\) Id. § 9(1).
\(^{15}\) Id. § 15.
\(^{16}\) Id. § 31.
\(^{17}\) See, e.g., Rich v. Class, 643 S.W.2d 872 (Mo. Ct. App. 1982).
ized as limited partnerships because: (1) the partnership format allows the income tax advantage of the pass-through of both income and losses to the investors (limited partners),\(^{18}\) (2) the investors can obtain the legal advantage of limited liability (an investor's liability for partnership obligations is limited to his investment in the limited partnership),\(^{19}\) and (3) the general partner/syndicator can retain control of the syndication allowing for centralized management.\(^{20}\) In a typical limited partnership, the general partner manages and controls the operations of the partnership and the limited partners/investors provide the capital as passive investors.

It is important to note that the death or bankruptcy of a limited partner, the assignment of a limited partner's interest, or a limited partner's withdrawal do not terminate the limited partnership.\(^{21}\) The death, bankruptcy or resignation of a general partner may terminate a limited partnership, but as a practical matter, continuity of life is generally present because most well-drafted partnership agreements provide a ready means for reconstituting and continuing the partnership upon such events. Unlike the corporate form, however, management has no true accountability to investors because a general partner does not come up for re-election annually as do corporate directors. In effect, the limited partner's role is a passive one even though under the law of some states limited partners can remove and elect a new general partner.\(^{22}\)

II. Management and Control of the S Corp

The S Corporation provides the flexibility sought by some promoters in determining how much participation of investors is desirable in a particular transaction. For example, if the intended general partner wishes to eliminate all investor participation, the S corporation could issue non-voting (or at least non-voting as to a particular issue) stock to the investors, and the voting stock to the general partner(s). Under the Uniform Limited Partnership Act, consent of a certain percentage of the limited partners to certain actions of the general partner is required.\(^{23}\) This consent would not be necessary in

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20. ULPA § 9; RULPA § 303(b).
21. ULPA §§ 19, 21; RULPA §§ 301, 704.
22. See, e.g., Del. Code. Annot. tit. 6, §§ 17-302, 303(b); RULPA §§ 302, 303(b).
23. See generally ULPA § 9; Prefatory Note to the 1985 amendments of the RULPA ("[T]he relationship among partners is consensual, and under some circumstances may require..."
the S corporation context. In addition, the possibility of a termination of the partnership (however unlikely) can be eliminated if the voting on such issue could be invested solely in the general partner.

Paradoxically, the S corporation can provide the converse: an opportunity for substantial participation in management, if so desired. In a limited partnership, the investor must scrupulously avoid any management activities or risk losing his limited liability status. Hence, if the investors desire to exercise some discretion and to oversee operations in a more active way, without losing their limited liability, the S corporation may provide an ideal substitute.

III. Transferability of Interests

A corporation enjoys free transferability of its shares, while a limited partnership must restrict transferability of its interests or create a possible “association” issue. While this can be an advantage of an S corporation over a partnership, it may be illusory, in that a resale market for S corporation stock may be as nonexistent as one for most limited partnership interests. In addition, it is likely that in practical circumstances S corporations will require some form of shareholder agreement restricting the sale of interests, at the very least by providing the corporation with a right of first refusal. Lastly, the transferability may not be entirely “free” for securities purposes. Assuming a private placement exemption has been used for the initial offering, the securities may need to be registered before they can be resold.

One point in the S corporation’s favor: although it is unlikely, if over 50% of the total interest in capital and profits of a partnership are sold or exchanged within a twelve month period, the partnership will automatically terminate for tax purposes. In an S corporation, the owners of over one-half of the corporation’s shares can elect to

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24. See generally ULPA § 7; RULPA § 303.
25. Reclassification of a partnership as an “association taxable as a corporation” would destroy the tax benefits by trapping the income and losses at the corporate level. Under Treas. Reg. § 301.7701-2, the characteristics of a corporation are listed as (1) continuity of life, (2) centralized management, (3) free transferability of interests and (4) limited liability. If an entity has three or more such characteristics, it will be taxed as a regular C (not S) corporation.
26. For example, S.E.C. Rule 144, which affects private placements of S years corporation stock as well as similarly placed partnership interest, restricts the resale of such interests for two years. 17 C.F.R. § 230.144 (1987).
terminate its S status and convert it to a C corporation,²⁸ leaving the matter to the discretion of the shareholders.

IV. CONTINUITY OF LIFE

The S corporation has a slight advantage over the limited partnership form in that a corporation has unquestioned continuity of life. Although generally under limited partnership law the death of a general partner (or retirement or other disability) can result in the dissolution of the partnership,²⁹ most partnership agreements provide mechanics for choosing a successor general partner. Accordingly, assuming good legal counsel in drafting the partnership agreement, this advantage is minimal.

V. LIMITED LIABILITY

While the Limited partners all enjoy limited liability in a limited partnership, there must be a general partner with general liability. This is usually the promoter or an affiliate of the promoter. Although a corporate entity is frequently chosen as the sole general partner, such corporation must meet certain net worth standards³⁰ for purposes of obtaining an advance ruling from the IRS on the issue of the partnership status. Although the exposure may be limited, it is nonetheless true economic exposure and one which, if an S corporation could be used instead of a limited partnership, the general partner would be able to avoid.

²⁹. ULPA, § 20; RULPA, § 402.
³⁰. These standards are set forth in Rev. Proc. 89-12, 1989-71 R.B. 22. Rev. Proc. 89-12 provides that a limited partnership with only corporate general partners will be deemed to lack the corporate characteristic of limited liability if the net worth of the general partners equals and is maintained at an amount equal to at least 10% of the total contributions to the limited partnership. Even if the 10% safe harbor is not met, Rev. Proc. 89-12 permits the IRS to determine that a partnership lacks the corporate characteristic of limited liability if the partnership demonstrates that either (i) the general partners collectively have "substantial assets" (other than the general partners' interest in the partnership) that could be reached by a creditor of the partnership; or (ii) the general partners individually and collectively will act independently of the limited partners. The IRS has indicated that a determination of net worth is satisfied separately for each limited partnership and is to be computed by excluding any interest in any limited partnership (and notes and accounts receivable from and payable to any limited partnership) in which the corporate general partner has an interest.

This Revenue Procedure and the other IRS requirements concerning corporate general partners are discussed thoroughly in R. HAFT AND P. FASS, INVESTMENT LIMITED PARTNERSHIPS AND OTHER PASS-THROUGH VEHICLES, § 4A.02[7] (1987).
VI. TRANSFERRING AN INTEREST WITHOUT RECOGNITION OF GAIN

Where a disposition of a partnership interest is considered, e.g., by sale or by gift to a related party or charity, there is most likely a corresponding creation of large amounts of taxable gain, frequently ordinary in character. Gain is realized to the extent that a partner is relieved of his allocable share of partnership indebtedness, assuming the same exceeds his basis.31

Depending upon the structure of the corporate indebtedness and shareholders' bases, the shareholders in an S corporation may be able to transfer stock to one or more lower-bracket individuals32 thereby reducing taxable income. Where an S corporation is used as the investment vehicle, in particular where the basis strategy of Revenue Ruling 75-144 has been utilized,33 equity interest may be transferred without triggering the recognition of gain provided under the partnership provisions discussed above. According to the financing structure approved by the Revenue Ruling and by Gilday v. Commissioner,34 the corporation becomes indebted to a third party lender, with the shareholders acting as guarantors. Where the S corporation defaults, the shareholders satisfy their guarantor obligations with their promissory notes and the third party lender releases the corporation from its liability. Thereafter, the shareholder possesses both an equity interest by reason of his stock ownership, and a creditor interest as a result of his subrogation to the rights of the original corporate third-party lender.35

A gift of S corporation stock does not relieve the donor-share-
holder of any liabilities and therefore will not trigger gain recognition. The donor/creditor will retain his creditor status and should continue to receive payment from the S corporation sufficient to cover his obligation to the original third-party lender. Accordingly, it is possible to dispose of S corporation stock without the adverse tax consequences produced in the partnership area. 36

VII. PASSIVE ACTIVITY LOSSES

In one of the most revolutionary changes in tax policy ever to be enacted, Congress, in the Act, abolished the “spillover” loss concept of prior law under which investors were allowed to engage in certain passive investments and use the non-cash losses from these investments (generated primarily by depreciation deductions and accrued expense items such as interest and fees) to offset taxable income from sources other than the passive activity which generated the loss. 37 Section 501 of the Act added new Code section 469 (entitled “Passive Activity Losses and Credits Limited”), generally effective for taxable years beginning after December 31, 1986. 38

Income from sources other than passive activities includes (1) earned income — which includes salary, bonuses, and other compensation for services; and (2) portfolio income — which includes income traditionally thought of as passive, such as interest, dividends, royalty or annuity income. 39 Dividends on C corporation stock constitute portfolio income; similarly, dividends paid by an S corporation that was formerly a C corporation, where the dividends are

36. This tax-saving technique is discussed at length in Mullaney and Blau, An Analytic Comparison of Partnerships and S Corps as Vehicles for Leveraged Investments, 59 J. TAX’N 142 (1983). According to the authors the sole cost of using the Rev. Rul. 75-144 financed S corporation is the gain realized on principal distributions with respect to shareholder indebtedness (citing Rev. Rul. 64-162, 1964-1 C.B. 304).


38. I.R.C. § 469 is an outgrowth of prior legislative efforts to impose limitations on the deductibility of artificial losses (the so-called “LAL rules” passed by the House as H.R. 10612, Nov. 12, 1975, but never enacted). See, e.g., H.R. Rep. No. 658, 94th Cong., 1st Sess. at 25-85 (1975). On December 22, 1987, President Reagan signed into law the Revenue Act of 1987, Pub. L. No. 100-203, § 10000, 1988 U.S. CODE CONG. & ADMIN. NEWS (101 Stat.) 1330-1, 1330-382. Under § 10211 of the 1987 Act the provisions of the passive loss rules are applied to each publicly traded partnership (defined as any partnership whose interests are (i) traded on an established securities market or (ii) readily tradable on a secondary market (or the substantial equivalent thereof)) separately. The effect of this provision is that the income from a publicly traded partnership may not be used to offset passive losses from other sources and the losses from such partnership are suspended and can only be deducted against the income from that partnership.

treated as derived from earnings and profits from a C corporation year under Code section 1368, are treated as portfolio income, even though the income or loss passed through to the S corporation shareholders would otherwise be treated as passive income.40

A passive activity is any activity which involves the conduct of any trade or business (including an activity involving research or experimentation within the meaning of Code section 174), in which the taxpayer does not "materially participate."41 Rental activities are passive whether or not the taxpayer materially participates.42 There is an exception where the taxpayer holds a "working interest" in an oil or gas property: an owner of such a working interest is permitted to deduct otherwise allowable losses attributable thereto, whether or not he materially participates in the activity. The working interest must be held "directly or through an entity which does not limit the liability of the taxpayer with respect to such interest."43

The rules of Code section 469 (the passive loss rules) deny (i) the deduction of losses from passive activities (called "passive activity losses" or "PALs") against income which is not from passive activities and (ii) the use of tax credits from passive activities (called "passive activity credits" or "PACs") to offset the tax liability on income which is not from passive activities.44 Accordingly, if an investor acquires an interest in a passive activity beginning in 1987 in

40. Portfolio income is described at I.R.C. § 469(e)(1)(A). Income from a real estate investment trust (REIT), regulated investment company (RIC, i.e., mutual fund), or real estate mortgage investment conduit (REMIC), interest on debt obligations and royalties from the licensing of property generally are included in portfolio income. See Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess. General Explanation of the Tax Reform Act of 1986, 231 (Joint Comm. Print 1987) [hereinafter, General Explanation of the 1986 TRA].


42. I.R.C. § 469(c)(2) (West Supp. 1988). There is a limited exception in the case of an individual taxpayer who actively participates in rental real estate activities. Such taxpayer may utilize a loss from such activities up to an aggregate amount of $25,000 to reduce earned income or portfolio income. This $25,000 amount is phased out by 50% of the amount by which the adjusted gross income of the taxpayer exceeds $100,000 for the taxable year. Accordingly, no such deduction is allowable where adjusted gross income reaches $150,000. I.R.C. § 469(i)(1)-(3).

43. I.R.C. § 469(c)(3)(A) (West Supp. 1988) (emphasis added). Accordingly, interests held by an S corporation shareholder or a limited partner in a partnership do not qualify for this exception because "the form of the ownership limits the taxpayer's liability." General Explanation of the 1986 TRA, supra note 40, at 252. Also specifically excepted from the definition of a working interest: rights to overriding royalties or production payments, and contract rights to extract or share in oil and gas profits without liability for a share of production costs.

which losses exceed income, the excess PALs or PACs will remain unused until the investor receives sufficient passive income to utilize them. A special rule permits cash out-of-pocket losses to be deducted against any type of income in the year of a complete disposition of a passive investment. 46

Code section 469 applies to individuals, individuals who are partners in partnerships and/or shareholders in S corporations. Thus, for partnerships or S corporations which (A) own rental activities, or (B) which operate a trade or business, the partners or shareholders respectively (absent certain participation requirements outlined below), will be subject to the PAL limitations. 46

A. Rental Activities.

A rental activity is broadly defined as an activity whose income consists of payments principally for the use of tangible property rather than the performance of substantial services. 47 Clearly a net lease of property constitutes rental activity. Where an activity is designated as a "rental activity," all losses and credits therefrom are PALs and PACs for each participant, regardless of whether he "materially participates" in the activity.

The Senate Finance Committee Report to the Act provides that prior law applicable in determining whether an S corporation had sufficient levels of passive rental income (as opposed to active business income) to qualify as an S corporation provides a useful analogy for purposes of determining whether rents are deemed to be derived from a rental activity under the passive loss rules. The Senate Report states:

[R]egulations applicable in interpreting [section 1372(e)(5)] provided that rents did not include payments for the use or occupancy of rooms where significant services were also rendered to the occupant (such as hotels and the like which furnish hotel services). The regulations further provided, 'services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered [sic] in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas

45. Id.
the furnishing of heat, light, ... the collection of trash, etc., are not considered as services rendered to the occupant."

1. The Dealer Issue.—Where an individual, partnership or S corporation owns and operates rental real estate (for investment and not for immediate sale), and then sells the real estate, income and loss from both the rental activity and the sale are deemed to be passive items from a rental activity. However, income or loss from the temporary rental of condominium units which are held for sale to customers in the ordinary course of a trade or business may be treated as income or loss from the trade or business of selling condominium units (and whether such is a passive activity will be tested under the “material participation” test discussed below).

Consider the situation where a developer has no interest in becoming a landlord but, in order to get a top price for the development, negotiates long-term leases for all the space before offering it for sale. Since it may take several months to get the property completely occupied, some of the early tenants may move in, and the taxpayer may operate the completed building prior to its sale. During this “lease-up” period the taxpayer will collect rent and incur operating expenses as well as debt service on the construction loan. Accordingly, substantial tax losses can be expected due to the operating expenses and interest in excess of rental income. The activity may not constitute “rental activity.” The Senate Report states that, “[a]n activity as a dealer in real estate is ... not generally treated as a rental activity.” Since many dealers of rental property have some rental activity between the time they acquire the property and the date they sell it, the facts and circumstances surrounding each case will need to be examined to determine the particular taxpayer’s underlying intent. Presumably, the longer the time period between completion of construction (or the purchase of the property) and the sale, the more likely the Internal Revenue Service (IRS) will contend that the property is not being held for sale, but is being operated as rental property.

49. This illustration was adapted from Hersh, Real Estate Dealers and Passive Activity Losses, 18 Tax Adviser 98 (1987).
51. Hersh, supra note 49 at 99. In the same vein, consider the following question. Where a developer holds raw land but decides not to develop a particular parcel, does that convert the expenses and gain or loss on sale into portfolio income or loss? Once again, “facts and circumstances” will be decisive in determining trade or business versus portfolio activity. One com-
Another situation exists where the owning entity determines to convert an apartment building to condominium units. In this example there are two separate activities: (1) the rental activity of owning and operating the project for investment, which ends when (2) the activity of selling condominium units begins. A similar bifurcation applies where a portion of rental property is actually used in a trade or business of the taxpayer and a portion is rented for profit. The Senate Report provides the following example:

[S]uppose a travel agency operated in the form of a general partnership has its offices on three floors of a ten-story building that it owns. The remainder of the space in the building is rented out to tenants. The travel agency expects to take over another floor for its own use in a year. The partnership is treated as being engaged in two separate activities: a travel agency activity and a rental real estate activity. Deductions and credits attributable to the building are allocable to the travel agency activity only to the extent that they relate to the space occupied by the travel agency during the taxable year.82

2. Regulatory Authority.—Code section 469(1) (formerly 469(k)) empowers the Treasury Department to issue regulations which will (1) define what constitutes an activity, material participation, and active participation; (2) provide that certain items of gross income are not to be taken into account in determining income/loss from an activity (and the treatment of expenses allocable to such income); (3) require certain net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity; and (4) provide for the determination of the allocation of interest expense.83 The Conference Report provides that this authority is to be exercised to protect the underlying purpose of the passive loss rules, i.e., “preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities.”84 The IRS has now issued the first installment of its regula-
tions (the Temporary Regulations) on passive activity losses.\(^5\) It provides six exceptions to the general rules used to determine a "rental activity:"

(a) The seven day rule. Any activity involving tangible property which is used by customers for seven days or less is not considered rental activity.\(^6\) This exception would cover the rental of such property as videocassettes, automobiles, tuxedos, and tools, and short-term use of hotel and motel rooms.\(^7\)

(b) Significant personal services. The use of tangible property for a period of more than seven days, but not greater than thirty days will not be deemed rental activity if significant personal services are provided.\(^8\) The operation of a hotel would not be considered rental activity.

(c) Extraordinary personal services. Even if a customer is provided the use of property for an average of more than thirty days,\(^9\) such use will not be considered rental activity if it is merely incidental to the customer's receiving "extraordinary personal services" from the property owner.\(^10\) For example, hospitals that provide boarding facilities to patients are not engaged in rental activity since the medical care provided constitutes "extraordinary personal services."\(^11\) Because this exception applies to use of property for periods which may average greater than thirty days, even nursing home facilities that provide rooms for long periods of time are not engaged in rental activity. As with the Significant Personal Services exception, extraordinary personal services are provided only if the services

\(^{57}\) "The rationale for the seven day rule is that a customer's use of property for seven days or less generally will require the person furnishing the property to provide services significant enough to justify the conclusion that the person is engaged in a service business rather than a rental activity." 53 Fed. Reg. 5687 (1988).
\(^{58}\) Temp. Treas. Reg. \$ 1.469-1T(e)(3)(ii)(B) (1988). Only services provided by individuals are treated as personal services. A taxpayer who rents his home for less than a month could not qualify for the exception simply by providing cable television for his tenants, since providing cable television does not constitute personal services. Personal services which do not satisfy this exception are deemed "excluded services," and include: (a) all service required by law, (b) services provided in connection with construction of improvements or repairs that extend the useful life of the property and (c) services commonly provided in conjunction with the rental of high grade commercial or residential property (e.g., janitorial services). Temp. Treas. Reg. \$ 1.469-1T(e)(3)(iv)(B) (1988).
\(^{59}\) The formula for determining average use of property by customers is found in section 1.469-1T(e)(3)(iii) of the Temporary Treasury Regulations of 1988.
are performed by individuals.

(d) Incidental to certain nonrental activities. This exception covers investment property that generates an "insubstantial" amount of rental income; lodging provided to the taxpayer's employees for the convenience of the taxpayer; temporary rental of property recently used by the taxpayer in a trade or business and rental of property held for sale in the ordinary course of the taxpayer's business.

(e) Non-exclusive use during defined hours. When property is made available to more than one customer during certain defined business hours it will not be considered a rental activity. Operation of a golf course or other similar facility comes within this exception. Here, customers are more properly characterized as licensees or invitees as opposed to lessees or tenants.

(f) Use of taxpayer's property by a business enterprise in which taxpayer has an ownership interest. Where a taxpayer makes property available for use by a partnership, an S corporation, or a joint venture in which the taxpayer owns an interest, he will not be deemed to engage in a rental activity. For example, where a taxpayer provides land as part of his contribution to a farming activity conducted as a joint venture. This exception will apply only if the taxpayer "provides the property in [his] capacity as an owner of such an interest" (i.e., one who provides a joint venture with the use of his land in return for his share of the profits from a farming venture, as distinguished from someone who acts in the capacity of a lessor to the joint venture). Furthermore, this exception will not apply if the enterprise which uses the property rents the property to any other party.

B. Trades of Business with No "Material Participation."

The second type of passive activity is a trade or business in which the taxpayer does not "materially participate." A taxpayer

64. Temp. Treas. Reg. 1.469-1T(e)(3)(ii)(E) (1988). While the regulations are unclear on this point, the phrase "non-exclusive use by various customers" suggests that this exception might apply if the property is made available only one customer at a time.
65. Supra note 63.
68. Supra note 63.
69. Id.
is treated as materially participating in an activity if the taxpayer is involved in the operation of the activity on a basis which is regular, continuous and substantial.\textsuperscript{71} This material participation test is applied to each taxpayer who owns an interest in a business as an S corporation shareholder. Accordingly, if such shareholder "materially participates" in the business of the S corporation, losses passed through to him can still be used to "shelter" other income. If not, such loss pass-throughs will only be able to be applied against income from the S corporation or other passive activities.

In determining "material participation," special rules apply in the case of corporations. A corporation (including an S corporation) which is subject to the passive loss provisions is treated as materially participating in an activity when one or more shareholders, owning in the aggregate more than 50\% of the corporation's outstanding stock, materially participate.\textsuperscript{72}

For example, a corporation with 5 shareholders, each owning 20 percent of the stock, is treated as materially participating in an activity if three or more of such shareholders so participate. If one of the three shareholders who so participated owned only 5 percent of the stock, and as a result the three participating shareholders owned only 45 percent of the corporation's stock, the corporation would not be treated as materially participating in the activity.\textsuperscript{73}

In the case of a grantor trust, to the extent the grantor or beneficiary is treated as the owner for tax purposes (sec. 671), the material participation of the person treated as the owner is relevant to the determination of whether income or loss from an activity owned through the grantor trust is treated as passive in the hands of the owner. Similarly, in the case of a qualified electing subchapter S trust (sec. 1361(d)(1)(B)) . . . [w]here the beneficiary is treated as the owner for tax purposes[, the material participation of the beneficiary is relevant to the determination of whether the S corporation's activity is a passive activity with respect to the beneficiary.\textsuperscript{74}


\textsuperscript{72} I.R.C. § 469(h)(4)(A) (West Supp. 1988).

\textsuperscript{73} General Explanation of the 1986 TRA at 242.

\textsuperscript{74} Id., supra note 40 at 242 n.33.
1. Material Participation.—The determination of what constitutes "regular, continuous and substantial" participation is a facts and circumstances determination under the considerations described in the Temporary Regulations,76 the Senate Report,77 and the Conference Report.78 These sources provide guidance in determining whether a taxpayer's participation in an activity is "material."

The Temporary Regulations contain the following seven alternate tests for satisfying the material participation standard, at least one of which must be satisfied in order to establish material participation in an activity. The first four tests are quantitative in nature, and are based on the number of hours spent participating in the activity during the year. They are:

(a) 500 Hours Test. The individual participates in the activity for more than 500 hours during the year.78

(b) Substantially All Participation Test. The individual's participation in the activity for the year constitutes substantially all of the participation of all individuals (whether or not owners) in the activity for the year, regardless of the time he spent participating in the activity.79

(c) 100 Hours/Most Participation Test. The individual participates in the activity for more than 100 hours during the year, and that individual's participation in the activity for the year is not less than the participation in the activity of any other individual (whether or not an owner) for the year.80

(d) Significant Participation Test. The activity is a "significant participation activity"81 for the year and his total participation in all of his significant participation activities for the year exceeds 500 hours.82

76. 1986 S. Rep at 731-36.
78. Temp. Treas. Reg. § 1.469-5T(a)(1) (1988). The IRS believes that the 500-hour test will have the effect of restricting deductions from the types of trade or business activities that Congress intended to treat as passive activities, since few investors in traditional tax shelters devote more than 500 hours during a taxable year to any such investment. In addition, the IRS believes that income from an activity in which an individual participates for more than 500 hours during a taxable year is not properly classified as income from a passive activity.79
81. Defined as a trade or business activity in which the taxpayer participates for more than 100 hours during the year in which he otherwise does not materially participate during the year. Temp. Treas. Reg. § 1.469-5T(c) (1988).
The following two tests are based on material participation by the taxpayer in prior years:

(e) Long-Standing Participation (Five-Year) Test. The individual materially participated in the activity under any of the other material participation tests for any five years (whether or not they are consecutive) out of the ten years immediately preceding the taxable year in question.83

(f) Personal Service Activity (Three-Year) Test. The activity is a "personal service activity" and the individual materially participated in the activity for any three years (whether or not they were consecutive) preceding the year in question. A "personal service activity" is defined as an "activity that involves the performance of personal services in (a) the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting or (b) any other trade or business in which capital is not a material income producing factor."84

(g) Facts and Circumstances Test. "Based on all of the facts and circumstances . . . the individual participated in the activity on a regular, continuous, and substantial basis during the year."85 Although future regulations are expected to better define the scope of the facts and circumstances test, the Temporary Regulations do contain some initial guidance. The Temporary Regulations provide that in order for the facts and circumstances test to be applicable, the individual must participate in the activity for more than 100 hours during the year, with the individual's participation in management activities (as contrasted with participation in operations) not being taken into account unless (a) no other person receives compensation for management of the activity (i.e., there is no paid manager), and (b) no person's participation in management of the activity exceeds that of the taxpayer for the year.86

83. Temp. Treas. Reg. § 1.469-5T(a)(5) (1988). Under Temp. Treas. Reg. § 1.469-5T(j), a taxpayer is deemed to have materially participated in an activity in a year beginning prior to January 1, 1987 only if his participation in the activity in the pre-1987 year exceeded 500 hours. This appears to be the only workable administratable alternative.

84. Temp. Treas. Reg. § 1.469-5T(a)(6) (1988). The IRS apparently believes that an activity in which an individual has materially participated over a long period of time or a personal service activity in which an individual has participated for a substantial period of time is likely to represent the individual's principal livelihood, rather than a passive investment.


2. Record Keeping Rules.—Notwithstanding the quantitative tests set forth, the Temporary Regulations expressly provide that taxpayers need not keep contemporaneous records of their hours of participation in each activity. The IRS recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their workdays, most individuals do not customarily maintain such records. Accordingly, under the Temporary Regulations, taxpayers will be allowed to prove the requisite number of hours by any reasonable means, including, but not limited to, appointment books, calendars, and narrative summaries. 87

3. Specific Types of Participation.—In determining whether an individual has materially participated in an activity for a year, the time spent on certain activities is not regarded as “participation” and is ignored. 88 Work performed by a direct or indirect individual owner (other than one who owns his interest only through a C corporation) is taken into account regardless of the capacity in which the work is performed (for example, as a partner, officer of a corporation, employee or independent contractor). 89 The following provides some guidance in determining the number of hours of participation:

(a) Participation as an Investor. Unless the individual is directly involved in the day-to-day management or operations of the activity, work performed in his capacity as an investor is ignored (for example, reviewing financial statements or other operational reports; preparing any financial or operational analysis for the individual’s own use; and monitoring the finances or operations of the activity in a non-managerial capacity). 90

(b) Non-Customary Owner Services. Work in connection with an activity is ignored if (a) one of the principal reasons the work is performed is to obtain material participation status to avoid the passive loss (or credit) disallowance rules and (b) the work is not customarily performed by an owner of this type of activity. 91 This rule would apply, for example, where a trade or business activity such as operating a professional football team generates losses for the year and an investor acts as a part-time receptionist in order to have spent enough time in the activity to achieve material participation for the year so that the losses are not passive losses.

(c) Spousal Participation. If an individual is married (and not legally separated) at year-end, regardless of whether a joint return is filed for the year, both spouses' participation in an activity during a year is aggregated for purposes of determining material participation and applying the other provisions of the passive loss rules. The aggregation of spouse participation in an activity occurs regardless of whether both spouses own interests in the activity or whether either spouse materially participated in the activity without regard to the other spouse's participation for the year.

4. Summary of Significant Considerations.—

(a) General Rule. The taxpayer or his spouse must have regular, continuous and substantial involvement in day-to-day operations. Mere approvals, management involvement, and providing legal, tax or accounting services are all generally insufficient to constitute material participation.

(b) Helpful Factors: The following factors will assist the taxpayer in meeting his burden of proving "material participation": (1) Regular presence at the place of business; (2) Knowledge and experience in the business activities (helps to negate the inference of a mere "rubber stamp" and the absence of meaningful authority); (3) The services provided by the taxpayer to the activity are the principal business of the taxpayer and (4) The performance of all required services for the activity.

C. Income Recharacterization Rules.

Code section 469 was intended to prevent taxpayers from using losses from rental activities and passive business activities to shelter any of three types of income: (a) personal service income, (b) active business income, and (c) portfolio investment income. Congress recognized the difficulty of writing statutory rules that would clearly distinguish income in these classes from income properly falling in the rental or passive business income category, and anticipated the need for additional rules to address transactions structured in order to maximize the amount of income treated as rental or passive business income. These are the "passive income generators" (PIGs) developed to enable investors to utilize otherwise suspended passive activity losses. Consequently, Congress enacted Code sections

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93. Id.
469(e)(1), (2) and (3), granting the IRS authority to prescribe regulations that eliminate certain items of gross income, or the net income from certain activities, from the computation of the passive activity loss and credit. Accordingly, the Temporary Regulations contain complicated recharacterization rules that provide that an individual's net income from certain activities does not constitute passive income.94

1. Significant Participation Activities.—Net income from each non-rental activity in which the taxpayer participated for more than 100 hours during the year and in which he did not materially participate for the year (a “significant participation activity”) is recharacterized as non-passive income, but only if (i) his share of the gross income from all significant participation activities for the year exceeds (ii) his share of the deductions from all of his significant participation activities for the year (this excess is called “Excess Significant Participation Net Income”). The percentage of his share of the net income from each such significant participation activity that is treated as non-passive income is computed by dividing (i) his Excess Significant Participation Net Income for the year by (ii) the amount his Excess Significant Participation Net Income for the year would have been if the income and deduction items were disregarded from all significant participation activities that generated a net loss for the year.95

2. Rental of Self-Developed Property.—If property that is used in a rental activity is sold (or otherwise disposed of) during a year in a transaction in which gain is recognized during the year, the net rental income for the year can be recharacterized as non-passive income under the Temporary Regulations if the taxpayer performed certain services. The rule only applies if (i) the rental commenced less than 24 months before the date of disposition (commencement of rentals is deemed to begin when substantially all of the rental property is held out for rent and is ready to rent and certificates of occupancy have been issued), regardless of when a tenant moves in or begins paying rent and (ii) the taxpayer materially participated (under any material participation other than 5-of-10 preceding year rule) or significantly participated (more than 100 house of participation) for any year in an activity that involved the performance of

services for the purpose of enhancing the value of the property sold (or enhancing the value of any property whose basis is used in determining the basis of the property actually sold). Value-enhancement services include services in connection with the construction, renovation and initial lease-up of the property.\textsuperscript{96}

3. Self-Rented Property.—Net rental income of a taxpayer for a year is recharacterized as non-passive income if the property is leased for use in any trade or business activity in which the taxpayer materially participates for the year (under any material participation test other than the 5-of-10 preceding year rule).\textsuperscript{97} This rule affects tenant-equity partnerships (in which a taxpayer receives an interest in a partnership that owns and leases the property) where part or all of the partnership's property is leased to the taxpayer's business. In such case, the tenant/partner's share of the net income of the partnership is recharacterized as non-passive income offsetting his non-passive trade or business deductions for the rents paid by him to the partnership.

4. Non-Depreciable Property Rents.—Net rental income for a year from an activity is treated as non-passive income if less than 30\% of the unadjusted basis of all property rented (or held for rental) in the activity during the year is depreciable property. Accordingly, income from a ground lease is non-passive income, regardless of whether the lease is a net lease. In the case of a single lease of both land and improvements, if the rental of the land and building is treated as a single activity, the portion of the rentals attributable to the land will be permitted to be passive income if the building and land, taken together, satisfy the 30\% test.\textsuperscript{98} The IRS has not yet defined the term "activity," but is expected to do so in the next set of passive loss regulations to be issued.\textsuperscript{99}

5. Lending Business/Equity-Financed Lending Rule.—Under Temp. Treas. Reg. § 1.469-2T(c)(3)(ii)(A), interest income from loans made in the ordinary course of a trade or business of lending money is not portfolio income. Absent a regulation expressly treating

\textsuperscript{99} In IRS Notice 88-94, 1988-35 I.R.B. 25 (August 29, 1988), the IRS stated that until forthcoming temporary regulations providing the definition of activity are issued, a taxpayer's operations may be treated as one or more activities "under any reasonable method."
income from such an activity as non-passive income, taxpayers could derive passive income from investments substantially similar to mutual fund investments by becoming passive investors in partnerships or S corporations that engage in a trade or business of lending equity funds contributed by the taxpayers. Accordingly, Temp. Treas. Reg. § 1.469-2T(f)(4) treats as non-passive income an amount of the taxpayer's gross income from an equity-financed lending activity equal to the lesser of (i) the taxpayer's equity-financed interest income from the activity or (ii) the taxpayer's net passive income from the activity. This rule applies to lending activities in which the average balance of debt incurred in the activity (determined at the entity level) does not exceed 80% of the average balance of interest-bearing assets held in the activity. In general, the taxpayer's equity-financed interest income from the activity is equal to the taxpayer's interest income from the activity multiplied by the activity's ratio of equity to interest-bearing assets. This rule is designed to treat as non-passive income only that portion of the taxpayer's income from the activity that approximates the product of (i) the average interest rate of the activity's interest-bearing assets and (ii) the taxpayer's equity contribution to the activity.\textsuperscript{100}

Liabilities incurred principally to meet the 80% test are disregarded.\textsuperscript{101} Accordingly, a mortgage lender that receives from its investors all of the funds that it has available to lend presumably could not satisfy the over-80%-test by restructuring its capitalization so that each investor contributes 19% and loans 81% of the required funds to the lending entity. In the case of a partnership or S corporation, the actual borrowings of the entity are the only liabilities that are treated as liabilities under the test (i.e., borrowings of the partners or S shareholders to enable them to make their capital contributions are not treated as liabilities of the partnership or S corporation).\textsuperscript{102}

\textbf{D. Impact of Material Participation Standard on S Corporation Shareholders and Limited Partners.}

Depending on the individual circumstances of the real estate business to be engaged in by an S corporation, each S corporation shareholder may find difficulty in demonstrating to the IRS that he or it materially participates in the business of the S corporation on a

"regular, continuous and substantial basis." However, for purposes of comparison of the S corporation entity with the limited partnership form of doing business, an interest in a limited partnership is conclusively presumed not to be one in which the taxpayer materially participates.

In general, under relevant State laws, a limited partnership interest is characterized by limited liability, and in order to maintain limited liability status, a limited partner, as such, cannot be active in the partnership's business. The presumption that a limited partnership interest is passive applies even where the taxpayer possesses the limited partnership interest indirectly through a tiered entity arrangement (e.g., the taxpayer owns a general partnership, or stock in an S corporation, and the partnership or corporation itself owns a limited partnership in another entity).

A limited partner's share of income or loss from a partnership operating a trade or business in which he is a limited partner will not always be passive income or loss, despite the fact that he will not be materially participating in the trade or business. For example:

1. A limited partner's salary will constitute income to him;
2. A limited partner's share of partnership portfolio income will retain its character as portfolio income;
3. The IRS is empowered to provide through regulations that limited partnership interests in certain circumstances will not be treated as interests in passive activities. The Senate Report indicates that such authority is to be "used to prevent taxpayers from manipulating the rule that limited partnerships generally are passive, in attempting to evade the passive loss provision."
4. The Temporary Regulations provide two exceptions to the general rule on limited partners. First, the general rule does not apply to an activity for a taxable year if (a) the taxpayer participates in the activity for more than 500 hours during the taxable year, or

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104. Id.
105. ULPA § 7; RULPA § 303.
106. The partner's share of losses from the passive activity are passive losses and cannot be used to offset salary (active) income.
107. I.R.C. § 469(h)(2) (West Supp. 1988). An example of such evasion would include attempting to treat income that generally is regarded as not passive in nature (e.g., personal service income), as passive and, accordingly, as shelterable. Even absent regulations, items such as guaranteed cash returns or portfolio income from a limited partnership are not to be regarded as passive.
(b) the taxpayer is treated as materially participating in the activity for the taxable year under either the longstanding material participant (five-year) test or the personal-service-activity (three-year) test. Second, the general rule does not apply with respect to a limited partnership interest in a partnership in which the taxpayer is also a general partner.¹⁰⁹

VIII. DETERMINING BASIS

Assuming the taxpayer can surmount the obstacle of the passive-loss rules, the amount of loss which a partner or an S corporation shareholder may deduct in any taxable year is also limited to his basis in either the partnership interest or the S corporation.¹¹⁰ Accordingly, the method for determining that basis is critical. In determining a limited partner's basis in his limited partnership interest, an allocable share of such partnership's nonrecourse indebtedness is included.¹¹¹ Under the rules governing S corporations, stock basis includes money plus the adjusted basis of other property contributed, less the amount of any encumbering liabilities assumed by the corporation.¹¹² Pursuant to these rules, an S corporation shareholder may not include any portion of the corporation's liabilities in determining his basis for stock in the S corporation. Accordingly, if a shareholder contributed cash to a corporation and corporation purchased real property, for cash and nonrecourse debt, his basis would not be as high as a partner whose partnership made the same investment.

Several suggestions have been made as methods of overcoming the S corporation shareholder's disadvantage in this regard. The cost direct method provides for the shareholders to borrow the necessary funds individually and then contribute same to the S corporation which, in turn, makes the cash purchase. This provides basis to the shareholders since it is a cash contribution from the shareholder to the S corporation. Ideally, shareholders may even be able to pledge their stock as collateral for their borrowings. However, the shareholders must remain personally liable on their obligations.

¹¹⁰. I.R.C. § 704(d) provides that a partner's distributive share of partnership loss is limited to the adjusted basis such partner has in his partnership interest. I.R.C. § 1366(d) restricts the aggregate amount of losses and deductions which an S corporation shareholder may take into account to the sum of his adjusted basis for his stock in the S corporation plus his adjusted basis of any indebtedness of the S corporation to the shareholder.
¹¹². I.R.C. § 358(a), (d) (1982).
Another method would be to have such prospective shareholders buy an undivided interest in the property under the same terms that the corporation would have and then contribute their interests to the S corporation, while retaining their personal liability on the mortgage.\footnote{Steinhauer, \textit{S Corporations and Small Real Estate Syndications}, 14 \textit{TAX ADVISER} 148 (1983).} While this would produce basis in the stock equal to the shareholders' basis in the property, and thus provide a basis for loss to the shareholders the same as that of partners in similar circumstances, it may be of limited practical value given the feasibility (or lack of it) in any particular transaction.\footnote{For example, banks may not be enthusiastic about having up to 35 “undivided interests” in a single piece of real property to rely on as collateral. It might make foreclosure on default of less than all the purchasers next to impossible.}

Another technique seeks to increase a shareholder’s utilization of corporate losses by increasing his adjusted basis in indebtedness of the S corporation to the shareholder, based upon the principles set forth in a 1975 IRS Revenue Ruling,\footnote{Rev. Rul. 75-144, 1975-1 C.B. 277.} as expanded upon by the 1982 Tax Court case, \textit{Gilday v. Commissioner}.\footnote{43 T.C.M. (CCH) 1295 (1982).} Under the facts as presented by the Revenue Ruling, an S corporation borrowed funds from a bank, with shareholder A executing a guarantee of the corporate indebtedness.\footnote{Note that the guarantee itself is insufficient to create S corporation basis. See Rev. Rul. 70-50, 1970-1 C.B. 178.} Subsequently, the S corporation defaulted and shareholder A executed his own promissory note as substitution for the corporate note. The IRS, basing its analysis upon the general principles of subrogation, determined that where the bank accepted the shareholder’s note and released the S corporation from its obligation, the shareholder assumed the bank’s position with respect to the loan and the S corporation became indebted to its shareholder. The IRS held that whether subrogation occurs depends upon state law. If subrogation does occur, the guarantor’s basis in the S corporation’s indebtedness is increased by the face amount of the shareholder’s note, even though it is unpaid.

The \textit{Gilday} case took Revenue Ruling 75-144 several steps further. In \textit{Gilday}, the substitution of the shareholder’s personal notes for those of the corporation took place only eight months after the initial corporate borrowing, and the parties agreed that the substitution was motivated by tax considerations. Nonetheless, the Tax Court sided with the shareholders and ruled that the transactions
created a valid corporation debt to the shareholders. The Court held that Revenue Ruling 75-144 was controlling, regardless of whether an actual state law obligation via subrogation arose when the shareholders substituted their note for the corporation's. Before Gilday, there was concern that corporate insolvency would be necessary to justify the substitution of the shareholder's note(s) for those of the corporation. Gilday suggests, however, that the creation of corporation indebtedness to the shareholder need not be precipitated by insufficient corporate revenues, and that pure tax consideration may serve as the motivation for the substitution of the shareholder's note.

IX. Allocation of Tax Items

All items of income, loss, deduction or credit (including all items of tax preference for purposes of the individual minimum tax) are allocated to the shareholders of an S corporation on a per share, per day basis. The only flexibility is created by Code section 1362(e)(3)(B) which permits, where an S corporation election is terminated, the S corporation to elect to allocate items of income and loss between its S and C corporation short taxable years by closing its books (rather than prorating such items on a daily basis between the two short years). That election requires the consent of all persons who are shareholders during the short S corporation year and on the first day of the C corporation short year.

This is in sharp contrast to partnership law which permits an allocation among partners of income or loss, or of particular items of income, loss deduction or credit, subject to the limitation that the allocations have "substantial economic effect." It has been the liberal allocation of tax items in partnership agreement which has provided the flexibility and appeal of most partnership arrangements.

118. Gilday, 43 T.C.M. at 1297.
119. In this regard, see also IRS Letter Ruling 8443002 (July 6, 1984), where the corporation had borrowed money from a bank for use in its car rental business. Each note was guaranteed by the shareholder and secured by corporate assets. To utilize the anticipated net operating loss for the year, the shareholder issued personal notes to the same bank and then lent the proceeds to the corporation, which used the funds to satisfy its notes to the bank. The bank did not release its security after the shareholder's personal notes were satisfied. The IRS acknowledged that the year-end exchange of notes produced a valid increase in the shareholder's basis.
123. See generally, P. FASS, R. HAFT, L. LOFFMAN & S. PRESANT, TAX ASPECTS OF REAL
X. ALLOWANCE OF LOSSES AND DEDUCTION

As discussed above, losses, if allowable under the new passive loss rules, are allowed only to the extent of the particular shareholder's aggregate adjusted basis in his stock and indebtedness of the S corporation to the shareholder.\textsuperscript{124} Under the law prior to 1982, if the loss for a tax year exceeded a shareholder's aggregate basis, computed at the end of the corporation's taxable year, the excess loss was permanently disallowed. Under the Subchapter S Act, however, such excess loss is treated as a perpetual carryover, available in any subsequent year to the extent that the shareholder's aggregate basis is restored.\textsuperscript{125} Accordingly, S corporations are no longer disadvantaged in this respect compared to partnerships, since in both entities excess losses may be taken in a later year.

XI. AT RISK

Prior to the Subchapter S Act, the at risk rules\textsuperscript{126} were imposed at both the corporate and shareholder levels. Under these rules the S corporation could not increase its net operating loss by any deductions for which it was not at risk. Similarly, the shareholder was restricted from taking a loss beyond his amount at risk in the corporation. With the changes in the law, however, both partnerships and S corporations now receive similar treatment; the at risk rules are applied at the partner or shareholder level only.\textsuperscript{127}

In conformance with the Proposed Regulations under Code section 465,\textsuperscript{128} the Tax Reform Act of 1984 (1984 TRA)\textsuperscript{129} provided that, for an S corporation, recourse borrowings by a corporation from a shareholder are to be included in amounts "at risk" under Code section 465.\textsuperscript{130} The 1984 TRA also changed the aggregation rules under Code section 465. Under prior law, an S corporation's activities relative to all items of property (e.g., film, oil or gas property, farm) in each category of property were treated as a single

\textsuperscript{124} See supra note 107, and accompanying text.
\textsuperscript{125} I.R.C. § 1366(d)(2) (1982).
\textsuperscript{126} See I.R.C. § 465 (1978) and the Proposed Treasury Regulations thereunder.
\textsuperscript{130} I.R.C. § 465(b)(3)(ii) (West Supp. 1988). This is in contrast to the general rule under I.R.C. § 465 that amounts borrowed from a person with an interest (other than as a creditor) in an activity cannot be taken into account in computing a taxpayer's amount at risk.
activity (i.e., aggregated). The treatment can be materially beneficial when there are losses with respect to some properties and gains with respect to other properties. Under the 1984 TRA, all Code section 1245 property leased or held for lease is to be treated as a single activity in the hands of the S corporation, but the activities of an S corporation relative to the items of property in the other categories can be treated as single activities under the principles of Code section 465(c)(3)(B) and section 465(c)(3)(C).

Under the Act, the present at risk rules are extended to the activity of holding real property. In the case of such an activity, there is an exception for certain third-party nonrecourse financing which is secured by the real property used in the activity. Under such circumstances, the taxpayer will be treated as at risk with respect to such financing. This is true notwithstanding that (1) the lender is related to the taxpayer (assuming such financing is commercially reasonable and on substantially the same terms as loans involving unrelated persons), and (2) the taxpayer acquired the property from a related party.

XII. DISTRIBUTION OF APPRECIATED PROPERTY


Prior to 1987, if an S corporation made a distribution (other than in complete liquidation) of appreciated real property with respect to its stock, under Code section 1363(d), gain (but not loss) was recognized to the S corporation in the same manner as if it had sold such property to the distributee at its fair market value. Property that is considered an obligation of the corporation was not included in the rule. Accordingly, distribution of a corporate note would not give rise to gain to the corporation, even if the value of the note exceeded its basis to the corporation, provided it was an obligation of the corporation itself.

If the shareholder/distributee owned 80% or more of the corpo-

132. I.R.C. § 456(c)(2)(B) (West Supp. 1988). Farming, oil, gas or geo-thermal exploration or development, and real estate which constitute a trade or business may be treated as a single activity if (1) the taxpayer actively participates in the management of the trade or business; or (2) the trade or business is carried on by an S corporation and at least 65% of the losses are allocated to persons participating in the management of that trade or business.
ration's stock, the gain would be ordinary income (assuming the property were depreciable under the principles of Code section 1239). While Code section 1363(d) required gain to be recognized if the corporation distributed appreciated property, it did not permit the deduction of loss if the corporation distributed depreciated property. There is no specific provision permitting losses to be netted against gains.

The gain at the corporate level was passed through to the shareholders, who then paid tax on the appreciation. In addition, recognition of gain to the S corporation occurred even if the distribution in question was a dividend fully taxable to the shareholder (i.e., considered to be made out of accumulated earning and profits). The shareholder's basis in his stock was reduced by the fair market value of the property, and he took a basis in the distributed property equal to such fair market value. Prior to the 1986 Act, where the distribution occurred in complete liquidation of the corporation, or to the extent it consisted of property permitted to be received without recognition of gain under Code section 354, 355 or 356 (concerning certain reorganizations), no gain or loss was recognized to the corporation.

B. Distribution After the Act.

The Act has deleted the exception from the recognition of gain provisions where distributions are made in "complete" liquidation. Accordingly, gain will be recognized at the corporate level where an S corporation distributes appreciated real property to its shareholders for any reason other than a qualifying distribution under the reorganization provision of Code sections 354, 355, and 356.

139. I.R.C. § 1363(e) (West 1988).
140. Obligations of the corporation, i.e., corporate notes, are still excluded from the recognition of gain. Probably touted as one of the most heinous acts committed against the corporate entity is the repeal of the General Utilities doctrine. See General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). Under the General Utilities doctrine, qualifying distributions or sales of corporate assets, through complete or partial liquidations, were not taxed at the corporate level. See, e.g., I.R.C. §§ 333, (repealed 1984), 336, 337, 338, and 311(d) before amendments by the Act. Under the Act ordinary corporate tax rates will be applied to previously unrealized appreciation in the assets of a C corporation resulting from the sale or distribution of such assets. Partial or complete relief from these provisions is available in certain circumstances where S corporation status is elected within the time limits provided. (The Act amended Code section 1374 governing S corporations and retitled it "Tax Imposed on Certain Built-in Gains.") This provision generally imposes a corporate-level tax on such "built-in"
As compared to an S Corporation, the partnership form retains the advantage because neither it nor the distributee partners will recognize gain (or loss) on the distribution of appreciated property, assuming certain types of assets are not involved in the distribution.\textsuperscript{141}

XIII. Audit Procedures

The Subchapter S Act restructured the entire administrative and judicial process to conform to the provisions governing partnerships.\textsuperscript{142} Prior to the Subchapter S Act, each shareholder’s liability was determined at the shareholder level, with duplicative proceedings sometimes resulting in inconsistent determinations with respect to the tax treatment of identical items to different shareholders.

XIV. Taxable Year

Code section 441(b)(1) provides that the term “taxable year” (tax year) generally means the taxpayer’s annual accounting period, whether it is a calendar year or a fiscal year. Code section 441(c) provides that the term “annual accounting period” means the annual period on the basis of which the taxpayer regularly computes its income in keeping its books. A “calendar tax year” is a period of 12 months ending on December 31;\textsuperscript{143} a “fiscal tax year” is a period of 12 months ending on the last day of any month other than December.\textsuperscript{144} The Code also provides for a “52-53 week” fiscal year under which the taxpayer regularly computes its income on the basis of an annual period which varies from 52 to 53 weeks, always ends on the same day of the week and always (1) on whatever date such same day of the week last occurs in a calendar month; or (2) on whatever date such same day of the week falls which is nearest to the last day of a calendar month.\textsuperscript{145}

Generally, both partnerships and S corporations must utilize a gains recognized by a former C corporation during the ten-year period beginning with the first day of the first taxable year for which the corporation becomes an S corporation. This tax is inapplicable: (1) where the corporation has always been an S corporation; and (2) where an S corporation election is made before January 1, 1987, even if such election is not effective until a taxable year beginning after December 31, 1986. In addition, certain qualified C corporation which elect small business status before January 1, 1989 may avoid the new built-in gains tax.

\textsuperscript{141} I.R.C. § 731(a)(1), (b) (1982); \textit{but see} I.R.C. §§ 751, 752 (1982).

\textsuperscript{142} \textit{See} I.R.C. §§ 6622-6232 (West Supp. 1988).

\textsuperscript{143} I.R.C. § 441(d) (West 1988).

\textsuperscript{144} I.R.C. § 441(e) (West 1988).

\textsuperscript{145} I.R.C. § 441(f) (West 1988).
calendar year for tax purposes.146 The Act requires all partnerships and S corporations to conform their tax years to that of the "owners." Under Code section 1378, as amended, the taxable year of an S corporation must be a "permitted year." A "permitted year" is defined as a calendar year or "any other accounting period for which the corporation establishes a business purpose to the satisfaction of the IRS." A deferral of income to shareholders is not a business purpose.147

Under the Act, a partnership must have the same tax year as that of its majority interest partners (partners having an aggregate interest in partnership profits and capital exceeding 50%), unless it establishes to the IRS's satisfaction that there is a good business reason for having a different taxable year.148 If the majority owners do not have the same tax year, the partnership must adopt the same tax year as its principal partners. (A principal partner is a partner having a 5% or greater interest in partnership profits or capital.) If neither the majority interest owners nor the principal owners have the same year, the partnership must adopt a calendar year as its tax year.149

Accordingly, either entity may elect a fiscal year if it can demonstrate a business purpose for so doing. The legislative history of the Act expresses the conferees' intent that (1) the use of a particular year for regulatory or financial accounting purposes; (2) the hiring patterns of a particular business; (3) the use of a particular year for administrative purposes; and (4) the fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis, ordinarily will not be sufficient to establish that the business purpose requirement for a particular taxable year has been met.150

In response to sharp criticism of the rules regarding taxable years provided in the Act, Congress, in the Revenue Act of 1987

147. I.R.C. § 1378(b), as amended by § 806(b) of the Act. The amendment is effective for tax years beginning after December 31, 1986.
150. 1986 Conf. Rep., supra note 54, at II-319; General Explanation of the 1986 TRA, supra note 5, at 537. According to the Conference Report, any S corporation (or partnership) may adopt, retain or change to a taxable year, under procedures established by the IRS, if the use of such year meets the requirements of Revenue Procedure 83-25 (1983-1 C.B.689) concerning the "25% test" (i.e., 25% or more of the taxpayer's gross receipts for the 12-month period in question are recognized in the last two months of such period). This requirement must have been met for the specified three consecutive 12-month period.
(1987 Act),\(^{161}\) permitted certain partnerships, S corporations and personal service corporations to elect a taxable year which is different from the required taxable year.

In general, partnerships and S corporations may elect\(^{162}\) a taxable year which has a "deferral period"\(^{163}\) of three months or less\(^{164}\) if they make "required payments" to the IRS; such payments are intended to represent the value of the tax deferral obtained by the owners of those entities through the use of a taxable year which is different from the required taxable year.\(^{165}\) Required payments made by a partnership and S corporation which elects a taxable year other than the required taxable year are not deductible by the partnership or S corporation (or by any other person); rather, these payments are in the nature of refundable deposits and do not earn interest. Furthermore, the payments are not passed through to partners or S shareholders and thus are not creditable against the federal income tax liabilities of partners or shareholders for any taxable year.\(^{166}\)

An entity is entitled to a refund of a required payment upon

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152. I.R.C. § 444 (West 1988). The election (a Section 444 election) is made with the IRS by the partnership, S corporation or personal service corporation itself and must be made for the entity's first taxable year beginning after December 31, 1986 by July 26, 1988. See Temp. Treas. Reg. §§ 1.444-1T, 1.444-2T and 1.444-3T.

153. The "deferral period" is the time from the end of the fiscal year to the end of the year otherwise required (December 31 for most entities owned by individuals). I.R.C. § 444(b)(4) (West 1988).

154. An entity may continue to use its last taxable year beginning in 1986 and need not change to a taxable year with a deferral period of no more than three months. I.R.C. § 444(b)(3).

155. A "required payment" is determined pursuant to an intricate calculation, which itself is phased over four years. The required payment for an election year is equal to the excess of (a) the "applicable percentage" of the "adjusted highest section 1 tax rate" multiplied by the "net base year income" of the entity over (b) the amount of the required payment for the preceding election year, if any. The "applicable percentage" is 25% for an election year beginning in 1987; 50% for 1988, 75% for 1989 and 100% thereafter. The "adjusted highest section 1 tax rate" is 36% for election years beginning in 1987, and for all other years is the rate of tax imposed by I.R.C. § 1 as of the end of the year preceding the election year, plus 1 percentage point. The "net base year income" of the entity is essentially the net income of the entity for the year prior to the election year which is attributable to the deferral period. Thus, if a partnership has a fiscal year ending September 30, 1987, has $1 million of net base year income, and wants to retain the fiscal year for the year ended September 30, 1988 (rather than closing such year on December 31, 1987), it must make an election for the 9/30/88 year. The required payment of tax on April 15, 1988 is the excess of (a) 1987 applicable percentage (25%) of (36%) times net base year income ($1 million times 3/12 deferral ratio) over (b) required payment for year ended 12/30/87 ($0): 25% of 36% times $250,000, less $22,500. I.R.C. § 7519 and Temporary Regulations thereunder.

termination of the Code section 444 election or upon liquidation of the entity. In addition, a continuing entity which maintains its Code section 444 election is entitled to a partial refund for any applicable election year if the required payment for such year is less than the required payment for the preceding year.\textsuperscript{157}

A personal service corporation may elect a taxable year which is different from its required taxable year if, upon failing to distribute certain amounts to employee-owners by December 31 of any taxable year, it defers certain deductions for amounts paid to such employee-owners.\textsuperscript{158}

XV. TREATMENT OF PAYMENTS UNDER CODE SECTION 267

Where an S corporation uses the accrual method of accounting, it will nevertheless be denied a deduction for amounts payable to a cash-method shareholder of the corporation until the day such item is includible in the gross income of the shareholder. This rule applies to amounts payable after December 31, 1983, and includes such items as salary and interest.\textsuperscript{159} For example, where an accrual method calendar year S corporation accrues salary in 1988 payable to a shareholder, but such payment is actually made in 1989, the accrued deduction is suspended until 1989 when received by the shareholder and includible in his income. Note this rule applies to any payment (ordinarily deductible) made to any person who owns (directly or indirectly) any of the stock of such corporation.\textsuperscript{160}

\textsuperscript{157} I.R.C. § 7519(c) (West Supp. 1988).
\textsuperscript{158} I.R.C. § 444(c)(2) (West 1988).
\textsuperscript{159} I.R.C. §§ 267(a)(e) (West Supp. 1988).
\textsuperscript{160} I.R.C. § 267(e)(1)(B)(ii) (West 1988). Under the law prior to the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 811 [hereinafter 1984 TRA], a deduction for an item of expense paid by an accrual basis taxpayer to a related cash basis taxpayer was permitted only if the payment of such expense was made within 2½ months after the close of the taxable year. Related taxpayers included corporations and their shareholders and certain family members, but did not apply to transactions between a partner and a partnership or to transactions between related corporations. Under the 1984 TRA, I.R.C. § 267 was amended to provide that an accrual basis taxpayer will be placed on the cash method of accounting with respect to "any deductions" (not only those deductions for business expenses and interest) owed to a "related" cash basis taxpayer. The accrual basis taxpayer will be denied the deduction until the related cash basis taxpayer is required to include the amount in income (i.e., when payment is made). The 1984 TRA repealed the rule of prior law that an accrual basis taxpayer must actually pay expense items incurred in a transaction with a related cash basis taxpayer with in 2½ months after the close of the accrual basis taxpayer's taxable year or be lost forever. In addition, the 1984 TRA applies to all deductible expenses (regardless of whether deductible under I.R.C. §§ 162, 163, and 212). The major change to I.R.C. § 267 is that the class of persons and entities included in the definition prior law relating to accruals by S corporations is expanded to include accruals by partnerships to partners, partners to partnerships and shareholders of S cor-
An accrual basis partnership will not be permitted to deduct a fee for services provided by a cash basis partner until the cash basis partner is required to include such amount in income (i.e., at the time such amount is paid). This applies to items of expense where payment is to be made to a cash basis partner who holds (actually or constructively) any capital or profits interest in such partnership or to a person related (within the meaning of Code sections 267(b) or 707(b)(1)) to the cash basis partner.\textsuperscript{161} With respect to guaranteed payments, such payments may be accrued and deducted regardless of when paid, but must be reported as income by the recipient when accrued, regardless of when payment is received.\textsuperscript{162} If an S corporation transaction contemplates that the promoters will sell real estate to an accrual basis corporation in exchange for corporate debt, accruing a portion of the interest, and the promoters own any of the S corporation’s stock, the above limitations will clearly restrict the structuring of such a transaction, compared to a similar partnership arrangement.

**Conclusion**

An S corporation has sometimes been referred to as a "partnership corporation," because it is generally not a tax-paying entity and all income and losses of the S corporation are, as is the case of a partnership, passed through to the shareholders for inclusion (or deduction) on their individual tax returns. However, for several reasons, the S corporation is not a preferred form for structuring a real estate investment, although it does have some limited utility in certain circumstances described below. The principal differences between an S corporation and the partnership are: (1) a shareholder in an S corporation cannot benefit from an increase in the basis of his stock for his proportionate share of the nonrecourse debt of the corporation and, because losses in excess of the shareholder’s basis are not currently deductible, the amount of losses a shareholder in an S corporation can deduct will be limited to his investment (for example, depreciation of the portion of the purchase price representing the mortgage, which would be allowed to a partner in a partnership but is not allowed to a shareholder in an S corporation);\textsuperscript{163} (2) the

\textsuperscript{161} I.R.C. § 267(e) (West 1988).
\textsuperscript{162} I.R.C. §§ 267(e)(4), 707(c) (West 1988).
\textsuperscript{163} It appears the denial of passive losses to shelter earned income and portfolio income will greatly reduce the importance of this difference. Since the only income passive losses can
shareholders of an S corporation (who must be U.S. resident individuals, estates and certain trusts) may not make special allocations of income, loss, or deduction of the corporation on a basis disproportionate to their stock interest in the corporation.  

An S corporation is often used in conjunction with a partnership. For example, despite the foregoing limitations, an S corporation will often be used to hold a 1% general partnership interest in a partnership (with the balance of the S corporation shareholders’ interest held as limited partners in the partnership) so as to have limited liability to creditors. The limitation on losses allocated to the S corporation can thus only apply to the extent of 1% of the losses of the venture, but limited liability is achieved.

Where the real estate investment is expected to produce losses, the “materially participates” requirement may be easier to satisfy in the S corporation context than in the limited partnership format, given the statutory conclusive presumption that “no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.” Accordingly, it appears there will be intensified interest in the S corporation entity, both for profitable and loss real estate activities.

The Appendix to this article compares certain tax and non-tax provisions relating to the partnership and S corporation structure.

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be used to shelter is passive income, the watchword will be profitable investments, and the determination of basis will become significantly less important.

164. Some commentators have suggested the use of stock options is an S corporation to shift percentage stock ownership at fixed times in the life of an S corporation to approximate special allocations. See, e.g., Bravenec and Lassila, The Choice of Tax Entity For Business Operations, 16 TAX ADVISER 239 (1985).

165. I.R.C. § 469(h)(2) (West 1988); see section VII of the text, supra.
## Appendix: Comparison of Partnership and S Corporation Provisions

<table>
<thead>
<tr>
<th>Non-Tax Characteristics</th>
<th>Partnership</th>
<th>S Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>Limited partners have limited liability, general partner(s) has unlimited liability.</td>
<td>All shareholders have limited liability.</td>
</tr>
<tr>
<td>Transferability of Interests</td>
<td>Restricted by partnership agreement, frequently with the partnership having right of first refusal. Usually relied upon as evidence of partnership status to prevent recharacterization as an association taxable as a corporation. Treas. Reg. § 301.7701-2(a). In addition, see securities law for additional restrictions on transferability.</td>
<td>Frequently, shareholders enter voluntary shareholder agreements with mutual rights of first refusal. Subject to same securities law restrictions on transferability. Also, transfer to ineligible shareholder terminates election.</td>
</tr>
<tr>
<td>Continuity of Life</td>
<td>Death, retirement, insolvency, disability of general partner may terminate partnership.</td>
<td>May continue indefinitely — unaffected by death, financial situation, etc. of individual shareholders.</td>
</tr>
<tr>
<td>Management</td>
<td>By general partner. A limited partner’s participation in management may create unlimited liability.</td>
<td>By board of directors, elected by shareholders. No restrictions on shareholder’s participation as officer or director, etc.</td>
</tr>
<tr>
<td>Eligible Investors</td>
<td>All</td>
<td>No corporations; no partnership; no non-resident aliens; only certain trusts and estates may be shareholders. IRC § 1361(b)(1). 35 (spouses count as one). I.R.C. § 1361(b)(1).</td>
</tr>
</tbody>
</table>
### A COMPARISON

<table>
<thead>
<tr>
<th>Different Classes</th>
<th>Can have different classes of limited partners, and general partner can have different interests.</th>
<th>Only one class of stock permitted. Voting differences are permitted. I.R.C. §§ 1361(b)(1)(D) and 1361(c)(4).</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Characteristics on Organization</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tax Status — IRS Ruling</strong></td>
<td>May have to satisfy the requirements of Rev. Proc. 72-13, 1972-1 C.B. 735 and/or 74-17, 1974-1 C.B. 438.</td>
<td>Should be no problem.</td>
</tr>
<tr>
<td><strong>Allocation of Income, Deductions, Credits, etc.</strong></td>
<td>Determined by the partnership agreement, provided such allocations have &quot;substantial economic effect.&quot; I.R.C. § 704(b).</td>
<td>Determined based on the per day, pro rata stock ownership of shareholders. I.R.C. § 1366. Suggested solutions: (1) use of partnership(s) of several S corporations; (2) use of debt instruments.</td>
</tr>
<tr>
<td><strong>Organizational Expenditures</strong></td>
<td>Must be amortized over at least 60 months. Also applies to syndication fees. I.R.C. § 709.</td>
<td>Must be amortized over at least 60 months. Start-up expenditures may also be amortized. I.R.C. § 248.</td>
</tr>
<tr>
<td><strong>Non-Tax Characteristics on Organization</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Contributions — with Appreciated Assets</strong></td>
<td>Tax-free, if it meets liberal rules of I.R.C. § 721; generally available after formation for adding additional partners.</td>
<td>Tax-free, if it meets requirements of I.R.C. § 351; usually only available on formation because of requirements that transferors must have 80% control.</td>
</tr>
<tr>
<td><strong>Contributions of Debt-Encumbered Property</strong></td>
<td>Gain unlikely — only to extent liability assumed by partnership exceeds investor's basis for his partnership interest, taking into account his allocable share of all partnership liabilities on the property to be contributed. I.R.C. §§ 721 and 752.</td>
<td>May result in gain to shareholder to extent debt exceeds shareholder's basis in property. I.R.C. §§ 351 and 357(c).</td>
</tr>
<tr>
<td><strong>Tax Treatment of Operations</strong></td>
<td></td>
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</tr>
<tr>
<td><strong>Tax year</strong></td>
<td>Tax year of majority partners unless you can show “business purpose.” Deferral of three months permitted under “required payment” provisions of 1987 Act. I.R.C. § 444.</td>
<td></td>
</tr>
<tr>
<td><strong>Federal Tax</strong></td>
<td>Form 1065, Information Return. Form 1120 S, Information Return.</td>
<td></td>
</tr>
<tr>
<td><strong>At-Risk Rules under I.R.C. § 465</strong></td>
<td>Applies at partner level. Amount of risk generally parallels partner’s basis in partnership interest, but no increase for his share of nonrecourse loans or share of recourse loans by other partners. Applies to shareholders. Amount at risk generally parallels a shareholder’s basis in stock and debt.</td>
<td></td>
</tr>
</tbody>
</table>
Distribution of Appreciated Property

No gain or loss to partnership or to partner, I.R.C. § 731(a) and (b), unless I.R.C. §§ 751, 752 apply. Partner's basis in his partnership interest reduced by partnership's basis in the distributed property; basis of remaining partnership property subject to readjustment. I.R.C. § 734(b).

(1) If distribution does not consist of certain qualified reorganization property, S corporation must recognize gain. I.R.C. § 1363(d).

Treatment to shareholder depends on whether corporation has earnings and profits and distributes cash in addition to property. Shareholder's stock basis reduced by property's fair market value. (2) If distribution consists of "built-in" gain property, and the corporation had been a C corporation at any time after January 1, 1987, the corporation will be subject to "built-in gains tax" — generally at the maximum rate applicable under I.R.C. § 11 — on the appreciation if the distribution is made within ten years of the date of the S corporation election. I.R.C. § 1374, as amended by the 1986 Act.
<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treatment of Income and Losses</td>
<td>Partnership income</td>
<td>Corporate income determined at entity level, and passed through to each shareholder, then taxed at individual rates. I.R.C. § 702.</td>
</tr>
<tr>
<td></td>
<td>determined at entity level, and passed through to each partner, then taxed at individual rates. I.R.C. § 702.</td>
<td></td>
</tr>
<tr>
<td>Limitation of Deduction of Losses</td>
<td>Limited (1) to basis of partnership interests; (2) by at risk rule; and (3) no passive losses deducted except against passive income. I.R.C. §§ 704(b), 465 and 469. Excess losses may be carried over indefinitely.</td>
<td>Limited (1) to basis in stock and to basis of S corporation's indebtedness to shareholders; (2) by at risk rules and (3) no passive losses deducted except against passive income. I.R.C. § 1366(d), 465 and 469. Excess losses may be carried over indefinitely.</td>
</tr>
<tr>
<td>Payment Expenses</td>
<td>(1) Guaranteed payment—partnership accrues and deducts; partner includes in income for year of partnership within which partner's taxable year ends. I.R.C. § 707(c). (2) Payment to partner acting in capacity other than as a partner—partnership accrues and deducts; partners includes in income when paid. I.R.C. §§ 707(a) and 267.</td>
<td>Where payment accrues to a cash method shareholder S corporation deducts when paid and shareholder includes when received. I.R.C. § 267.</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>Not Available.</td>
<td>Available only to shareholders/employees owning 2% or less of stock. I.R.C. § 1372.</td>
</tr>
<tr>
<td>Topic</td>
<td>Description</td>
<td>Description</td>
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<td>-------------------------------------------</td>
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<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Retirement Plans</td>
<td>Keogh plans generally subject to same limits on contributions and benefits that apply to qualified corporate plans.</td>
<td>Eligible for a wide variety of defined contribution plans. However, retirement plans may not hold S corporation's own stock in trust for employees.</td>
</tr>
<tr>
<td>Employment Taxes (F.I.C.A.)</td>
<td>Self-employment tax applies to salary and drawings.</td>
<td>To the extent shareholder receives a salary, tax payable by both corporation and employees, same as C corporation. F.I.C.A. not applicable to shareholder distributions.</td>
</tr>
<tr>
<td>State Income Tax Consequences</td>
<td>Generally speaking, no problem. Limited partnership form recognized in almost all jurisdictions.</td>
<td>Many states do not recognize S corporation status — accordingly, may have double tax at state level; also, almost all states impose franchise tax on S corporations.</td>
</tr>
<tr>
<td>Tax-exempt Income</td>
<td>Tax-exempt income retains its character when passed through to partners.</td>
<td>Tax-exempt income retains its character when passed through to shareholder. It increases shareholders' stock bases, but does not increase accumulated adjustment account I.R.C. § 1368.</td>
</tr>
<tr>
<td>Basis Determination</td>
<td>Equal to money and basis of property contributed, plus partner's pro rata share of partnership liabilities. I.R.C. §§ 722, 752.</td>
<td>Equal to money and basis of property contributed — less any liability assumed by the corporation. I.R.C. §§ 351 and 358(a).</td>
</tr>
<tr>
<td>Contribution of Property Where Basis and Fair Market Value Are Not the Same</td>
<td>Carry-over basis; within limits, ability to adjust available under I.R.C. § 704(c).</td>
<td>Carry-over basis; no adjustment provision.</td>
</tr>
</tbody>
</table>
Adjustments to Basis

- Basis increased by partner's share of income and certain debt;
- decreased by partner's share of losses and by certain distributions, including reduction of debt.

Basis Adjustment for Assets of Entity upon Transfer of Interests by Sale, Exchange or Death of Partner

- Partnership may elect to adjust basis in its assets to reflect transferor/partner's basis in the partnership. I.R.C. § 754.

Basis of Distributed Property

- Carry-over from partnership if not in liquidation of partner's interest. I.R.C. § 732(a);
- in liquidation of partner's interest, substituted basis from partnership interest, I.R.C. § 732(b).

Transactions Between Related Parties

- No capital gain if depreciable asset to partnership and partner's interest is at least 50%; no loss recognized if partner's interest exceeds 50%. I.R.C. § 707(b).
- IRS may reallocate where reasonable compensation not received for service rendered, I.R.C. § 704(e).

- Losses first reduce stock basis, then basis in shareholder loans. Gains first increase basis in shareholder loans, then stock basis. I.R.C. § 1367.

- No similar election.

- No capital gains if depreciable asset and partnership and partner's owns at least 50% of stock. I.R.C. § 1239.

- Same — I.R.C. § 1366(3).

- Losses not allowed on transaction between partnership and greater-than-50% partner. I.R.C. § 707(b)(1).

- Losses not allowed on action between S corporation and greater-than-50% shareholder. I.R.C. § 267(a)(1).
<table>
<thead>
<tr>
<th>Terminations/Liquidations/Sales</th>
<th></th>
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<tbody>
<tr>
<td><strong>Termination of Status</strong></td>
<td>Sales or exchange of at least 50% of partnership interests within 12 months causes termination for tax purposes. I.R.C. § 708(b) Majority of shareholders may elect to terminate status. I.R.C. § 1362(d). Automatic if eligibility requirements are violated.</td>
</tr>
<tr>
<td><strong>Liquidation</strong></td>
<td>Distribution is tax free, except that ordinary income may result to a partner for his interest in I.R.C. § 751 assets. I.R.C. §§ 731 and 751. Generally, shareholder treated as having sold his stock, any gain is capital, unless corporation is collapsible (I.R.C. § 341) or stock is &quot;dealer&quot; stock.</td>
</tr>
<tr>
<td><strong>Capital Gain(^1) Upon Sale of Interest</strong></td>
<td>Yes, except to extent gain is attributable to unrealized receivables or substantially appreciated inventory. I.R.C. §§ 741, 751. Yes, unless shareholder is dealer or corporation is collapsible. I.R.C. § 341.</td>
</tr>
<tr>
<td><strong>Loss on Sale or Worthlessness of Equity Interest</strong></td>
<td>Capital loss(^1) on sale. I.R.C. § 741. IRS maintains capital loss on worthlessness. Rev. Rul. 76-189, 1976-1 C.B. 181. Capital loss, unless the stock is dealer stock or I.R.C. § 1244 stock.</td>
</tr>
<tr>
<td><strong>Post-termination transition period</strong></td>
<td>No comparable provision. Shareholder may utilize carryover of net losses in excess of basis if stock basis is increased during this period; shareholders may receive cash distributions of accumulated adjustments account. I.R.C. §§ 1366(d)(3), 1371(e) and 1377(b).</td>
</tr>
</tbody>
</table>
