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Getting out of a Business—Tax Costs and Opportunities in Exiting a Closely Held Business

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1996

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Getting Out of Business: Tax Costs and Opportunities in Exiting a Closely Held Business

Abstract
The primary purpose of this article is to encourage closely held business owners and their lawyers to consider exit costs, opportunities and strategies when making the initial choice-of-entity decision. A secondary purpose is to provide information about tax consequences and exit strategies useful to owners of businesses that are already up and running, whether in drafting a buy-sell agreement or planning for a specific transaction. Therefore, the article begins by comparing the major tax consequences of exiting the alternative entity types available to closely held businesses for tax purposes—C corporations, S corporations and partnerships. Part II of this article provides a brief description of the general tax rules governing dispositions of business interests. It provides a brief overview and starting point for the detailed analysis that follows. Detailed descriptions of the tax consequences of dispositions by Subchapter C shareholders, Subchapter S shareholders and partners follow in Parts III-V. Along the way, strategies are suggested for minimizing tax costs and making the most of tax opportunities when getting out of the alternative entities. Finally, Part VI concludes by examining the significance of differences among the tax costs and opportunities associated with each type of entity in making the initial choice-of-entity decision for a closely held business.

Keywords
Corporations, business law, shareholders, Deferral Transactions, stocks, taxation

Disciplines
Corporation and Enterprise Law | Tax Law
GETTING OUT OF A BUSINESS—TAX COSTS AND OPPORTUNITIES IN EXITING A CLOSELY HELD BUSINESS

Denise Roy†

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I. INTRODUCTION

When the owner of a closely held business wants to leave an ongoing business, she has three basic options. She can sell her interest to a third party, sell her interest to remaining owners or have the business buy out her interest.1 Viewing these options from the departing shareholder's perspective, each accomplishes the same pre-tax economic result: the departing shareholder relinquishes her interest in the business in exchange for consideration equal to the value of the interest.2 Nonetheless, each of these alternatives may be taxed differently, depending on the disposition structure chosen, the type of business entity involved, the nature of the consideration and, sometimes, the identity of the buyer. This article focuses on the tax consequences of a complete termination of a business owner's direct interest in a business that continues to operate after her termination.3 It addresses transfers for consideration only. Therefore, it primarily addresses complete redemptions4 and sales and does

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1. She may choose a combination of these options, such as a part-sale/part-redemption. See, e.g., infra Part III.C.

2. Moreover, viewed from the remaining owners perspective, a sale to the remaining owners may be structured to leave the remaining owners with the same proportionate ownership interests they would have if the business were to redeem the interest of the departing owner. For instance, if three owners share equally in a business (so that each has a 33-1/3% interest), redemption of one owner will leave each of the remaining owners with a 50% interest in the business. The same result could be obtained by having each of the remaining owners purchase one-half of the 33-1/3% interest of the departing owner. The difference between these options, of course, may be the source of funding for the purchase. A redemption is funded by the resources of the business, and therefore reduces the size of the business, while a sale by remaining owners is funded by the remaining owners, leaving the business assets intact. Even in the sale context, though, business resources may ultimately be used to fund a purchase by remaining owners to the extent they borrow against their business interests or use business distribution proceeds to pay for the departing owner's interest.

3. This article refers to shareholders, partners and LLC members as "owners," to corporations, partnerships and limited liability companies as "businesses," and to corporate stock and partnership interests as "interests." All owners are presumed to be individuals unless otherwise indicated.

4. For purposes of this article, a "redemption" is a purchase by the business of all or a portion of an owner's interest in the business in exchange for cash or property. See, e.g., I.R.C. § 317(b). Although partnership withdrawals or liquidations (see I.R.C. §§ 761(d), 736(a)) are not strictly speaking "redemptions" (because the partnership is viewed as an aggregation of the owners' interests rather than as an entity in this context) the article sometimes uses "redemption" in the partnership context to facilitate comparison with the identical corporate transaction. In general, the tax treatment of redemptions varies depending on the type of entity, whether the redemption is partial.
not cover non-redemptive distributions, donative transfers or liquidations of the entire business.\footnote{5}

The primary purpose of this article is to encourage closely held business owners and their lawyers to consider exit costs, opportunities and strategies when making the initial choice-of-entity decision. A secondary purpose is to provide information about tax consequences and exit strategies useful to owners of businesses that are already up and running, whether in drafting a buy-sell agreement or planning for a specific transaction. Therefore, the article begins by comparing the major tax consequences\footnote{6} of exiting the alternative entity types available to closely held businesses for tax purposes—C corporations, S corporations and partnerships.\footnote{7} Part II of this article provides a brief description of the general tax rules governing dispositions of business interests. It provides a brief overview and starting point for the detailed analysis that follows. Detailed descriptions of the tax consequences of dispositions by Subchapter C shareholders, Subchapter S shareholders and partners follow in Parts III-V. Along the way, strategies are suggested for minimizing tax costs and making the most of tax opportunities when getting out of the alternative entities. Finally, Part VI concludes by examining the significance of differences among the tax costs and opportunities associated with each type of entity in making the initial choice-of-entity decision for a closely held business.\footnote{5}

or complete and whether cash or property is transferred by the business. For purposes of this article, only complete redemptions will be addressed.

5. Of course, the choice of disposition structure will also be influenced by many nontax considerations, including the availability of a third party purchaser, the willingness of remaining owners to admit a new owner, the source of funds to acquire the interest, the liquidity and timing of payments desired by the departing owner. The article addresses these nontax considerations only to the extent they interact with disposition tax consequences.

6. In general, the following factors are considered in evaluating the tax consequences of alternative structures (1) the rate of tax on business income (taking into account the single (pass-through) tax versus double tax, the corporate rate versus individual rate, and capital gains rate versus ordinary income rate) and (2) the timing of business income taxation, including deferral of tax and acceleration of deductions and exclusions.

7. Partnership tax treatment applies to limited liability companies (LLCs) and limited liability partnerships (LLPs) unless otherwise indicated.

8. All references and citations to statutory provisions in this article are to sections of the Internal Revenue Code of 1986 (Code or I.R.C.), as amended, unless otherwise indicated. All references and citations to regulations are to Treasury Regulations (Regulations) under the Internal Revenue Code of 1986, as amended, unless otherwise
II. GENERAL DESCRIPTION OF DISPOSITION TAX CONSEQUENCES

A. Owner Treatment

The owner who disposes of an interest in an ongoing business is generally treated as having made a taxable sale or exchange of a capital asset. Thus, disposition proceeds will be taxed, but only to the extent they exceed the owner's tax basis in her interest. Moreover, such gain will be taxed at the favorable capital gains rate if, as is usually the case, the owner's interest is a capital asset held for more than one year. However, as detailed below, there are a number of important deviations from these general rules. Two of the more significant are (1) the possibility that an otherwise "complete" redemption of a C corporation shareholder who retains a continuing constructive ownership interest may be taxed as an ordinary income dividend, and (2) the fact that distributions of appreciated property by a partnership are generally tax-free to both the partnership and the departing partner.

B. Business Treatment

When the departing owner sells to a third party or a remaining owner, the business itself does not recognize a tax gain or loss. Moreover, partnerships may generally distribute appreciated property in redemption of a partnership interest indicated.

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9. Such a disposition may be by sale or redemption.
10. The business may be a C corporation, S corporation or partnership.
11. See, e.g., I.R.C. § 1221; see also infra Parts III.A. (discussing treatment of the owner upon disposition of an interest in a C corporation), IV.A. (discussing treatment of the owner upon disposition of an interest in an S corporation), V.A. (discussing the treatment of the owner upon disposition of an interest in a partnership, LLC, or LLP).
12. See infra Parts III.A., IV.A., V.A.; see also I.R.C. § 1001(a) (determining the amount of gain or loss recognized on the sale or disposition of other property).
13. Conversely, the departing owner will recognize a capital loss to the extent her adjusted basis exceeds the disposition proceeds. See infra Parts III.A.1., IV.A., V.A.
14. See infra Part III.B.2. (discussing the risk that a redemption distribution may be taxed as an ordinary income dividend).
15. See infra text accompanying notes 152-53; Parts V.B.3.a-b. (discussing the consequences to a partner leaving the partnership).
16. The business itself is not a party to such transaction and therefore will not be taxed unless the transaction is somehow recharacterized as a different transaction under substance over form or step transaction authority. See infra note 22; Parts III.B.3, V.A.
without triggering taxation of the gain.\textsuperscript{17} By contrast, both Subchapter C and Subchapter S corporations must recognize gain on the disposition of \textit{appreciated} property in redemption of stock.\textsuperscript{18} Any such C corporation gain is taxed at the corporate level and does not affect the amount of gain or loss recognized by the departing shareholder on the redemption.\textsuperscript{19} On the other hand, any such S corporation gain is taxed pro rata to all the S corporation owners, causing a corresponding stock basis increase that does reduce the amount of gain, or increase the amount of loss, recognized by the departing owner on the redemption.\textsuperscript{20} No nonliquidating business is allowed to recognize a loss on a distribution of \textit{depreciated} property in redemption of an owner's interest.\textsuperscript{21}

III. DEPARTING OWNER IS A SUBCHAPTER C SHAREHOLDER

A. Sale To a Third Party or Remaining Owner

1. Taxable Sale Rules

In general,\textsuperscript{22} a shareholder who sells her stock in a C corporation recognizes taxable gain to the extent the amount realized\textsuperscript{23} exceeds her adjusted basis in the stock.\textsuperscript{24} The gain will be characterized as long-term capital gain subject to the

\begin{itemize}
\item \textsuperscript{17} See infra Part V.A.; see also I.R.C. § 731(a), (b) (determining whether gain or loss to the partner and partnership is recognized upon distribution to the partner).
\item \textsuperscript{18} See infra Parts III.B.1, IV.B.
\item \textsuperscript{19} See infra Part III.B.4.
\item \textsuperscript{20} See infra note 144.
\item \textsuperscript{21} See infra notes 104, 139, 217.
\item \textsuperscript{22} Because the business is not a party to this type of transaction, the discussion that follows focuses on the tax treatment of the owner only. Moreover, because the tax treatment of the buyer (other than the business itself) is unlikely to influence the choice of basic disposition structure (e.g., sale versus redemption), this article will not consider the tax consequences to any outside or remaining owner buyer. However, tax consequences of any buyer may well influence disposition choices other than the basic structure of the disposition, such as the form of consideration to be paid for the stock (e.g., cash, appreciated property or installment note). Therefore, a departing owner is well advised to consider the tax consequences to all parties in negotiating the terms of the disposition. The benefit of tax savings to any party may be shared, as negotiated by the parties; conversely, tax costs of the buyer may mean a reduced purchase price for the departing owner.
\item \textsuperscript{23} Amount realized is the cash plus the fair market value of any property received in a disposition of property. I.R.C. § 1001(b).
\item \textsuperscript{24} I.R.C. § 1001(a).
\end{itemize}
favorable capital gains rate if the stock was a capital asset in the hands of the shareholder and the shareholder held the stock for more than one year. The departing shareholder will take a cost basis in any property received in a taxable sale and will have a holding period in such property that begins with the sale date.

2. Opportunities To Exclude or Defer Taxable Shareholder Gain

There are a number of means by which the owner of stock in a closely held C corporation may exclude, avoid or defer taxable gain on a sale of the stock, including the fifty percent exclusion of gain on certain small business stock, deferral of gain on sale to a spouse or former spouse, deferral of gain on sale to an employee stock ownership plan (ESOP), deferral of gain by use of an installment sale, and avoidance of gain on stock held until death. These will be addressed in order in the following paragraphs.

a. Fifty Percent Exclusion of Gain on the Sale of Certain Small Business Stock

Noncorporate sellers of stock in certain small business corporations may be eligible to exclude fifty percent of the gain

25. Net capital gains are subject to a top tax rate of 28%, which is considerably lower than the top marginal rate of 39.6% that applies to ordinary income. I.R.C. § 1(a)-(d), (h). Note that the effective top marginal individual rate on ordinary income can be higher than the nominal 39.6% rate once the personal exemption phase-out, I.R.C. § 151(d)(5), limitation on itemized deductions, I.R.C. § 68, and wage cap on the Medicare portion of payroll taxes, I.R.C. § 3121(a)(7) (B), are taken into account.

26. If the shareholder is not a dealer in stock, then the stock is likely held as a capital asset. See I.R.C. § 1221(1).

27. I.R.C. § 1222(3). This analysis assumes that I.R.C. §§ 304, 306 and 341 do not apply to recharacterize the transaction.


29. Cf. I.R.C. § 1223. Such a holding period is used to determine whether capital gains and losses are considered long-term or short-term for purposes of determining the extent to which the special capital gains rate applies. Id.


32. I.R.C. § 1042.

33. I.R.C. § 453.

34. I.R.C. § 1014.

35. Note that § 1031 deferral of gain for like-kind exchanges does not apply to exchanges of stock for stock. I.R.C. § 1031(a)(2)(B).
realized on the sale.\textsuperscript{36} Stock is “qualified small business stock” if it was acquired by original issue from a qualified domestic C corporation after August 10, 1993,\textsuperscript{37} in exchange for: (1) cash; (2) qualified small business stock; (3) property other than stock; or (4) services.\textsuperscript{38} To be “a qualified small business”: (1) the aggregate gross assets of the issuing C corporation, or any predecessor, must not have exceeded fifty million dollars at any time on or after August 10, 1993, until immediately after the shareholder acquired the stock;\textsuperscript{39} (2) the corporation must have met an active business requirement during substantially all the shareholder’s holding period for the stock;\textsuperscript{40} and (3) the corporation must not have made certain stock redemptions.\textsuperscript{41} The fifty percent exclusion is available to the noncorporate shareholder who holds qualified small business stock for at least five years.\textsuperscript{42} The selling shareholder is subject to a ceiling on excludable gain equal to the greater of (1) ten million dollars over the shareholder’s lifetime, or (2) ten times shareholder’s aggregate adjusted basis in targeted stock disposed of by the shareholder during the year.\textsuperscript{43}

\textbf{b. Deferral of Gain on Transfers Between Spouses}

When each spouse has an interest in a closely held business, it may be necessary or desirable for one of the spouses to sell-out in connection with a divorce. One option is to have the spouse who will leave the business transfer or sell his or her interest to the spouse who will remain with the business. The remaining

\begin{itemize}
  \item \textsuperscript{36} I.R.C. § 1202. One-half of the excluded gain is an alternative minimum tax preference. I.R.C. § 56.
  \item \textsuperscript{37} I.R.C. § 1202(c)(1).
  \item \textsuperscript{38} A partner or Subchapter S shareholder seeking the exclusion must have continuously held his interest in the pass-through entity since the time the stock was acquired by that entity. I.R.C. § 1202(g)(3).
  \item \textsuperscript{39} I.R.C. § 1202(d).
  \item \textsuperscript{40} I.R.C. § 1202(c)(2)(A). A corporation meets the active business requirement if at least 80% of the assets of the corporation are used by the corporation in the active conduct of one or more qualified trades or businesses. Active conduct includes start-up activities and certain research activities. I.R.C. § 1202(e)(1)(A), (e)(2). ‘Qualified trade or business’ is defined by excluding a host of businesses, including specific service businesses (e.g., in the fields of law, accounting, health, architecture or consulting), banking, insurance, farming, mining, lodging and restaurant businesses. I.R.C. § 1202(e)(3).
  \item \textsuperscript{41} I.R.C. § 1202(c)(3).
  \item \textsuperscript{42} I.R.C. § 1202(a), (b)(2).
  \item \textsuperscript{43} I.R.C. § 1202(b)(1).
\end{itemize}
spouse will receive the interest tax-free with a carryover basis under I.R.C. Section 1041. Thus the basis of the interest in the hands of the remaining spouse will be the same as it was in the hands of the departing spouse before the transfer, and tax on any appreciation or deduction of any loss in the value of the interest will be deferred until the remaining spouse later disposes of the interest. This carryover basis rule applies even if the remaining spouse pays for the interest.

Any payment of cash by the remaining spouse may be treated as deductible/includable "alimony" if the alimony definition of I.R.C. Section 71 applies. In fact, there is nothing in the tax definition of "alimony" to prevent explicit use of alimony to compensate for property interests. In this event, the "exchange" described above will be analyzed as two separate events: (1) the tax-free transfer of a business interest to the remaining spouse under I.R.C. Section 1041, and (2) the payment of "alimony" that is deductible to the remaining spouse and includible in the income of the departing spouse.

c. Deferral of Gain on Transfers to Employee Stock Ownership Plans

The tax on certain ESOP transactions may be deferred by rolling the proceeds over into certain qualified investments. Sale to an ESOP may be one of the few situations in which an outsider (the employee) will be willing to purchase less than a controlling interest in an ongoing business. Qualified lending institutions can exclude from income up to fifty percent of loan proceeds if the loan qualifies as a "securities acquisition loan" under Code Section 133. Amounts loaned by a company to an


ESOP for purchase of securities may be deductible—both principle and interest—to the business. This deduction may increase the business’s deduction for deferred compensation over what would be available with other retirement plans.

d. Deferral of Gain under the Installment Method

The selling shareholder may be able to use the installment method to defer gain on an installment sale of stock by agreeing to accept some portion of the purchase price in the form of deferred payments.46 The installment method will not be available, however, if the purchaser’s note is payable on demand, issued by a third party or readily tradable, or if the selling shareholder is a dealer in stock.47

e. Deferral of Gain under the Tax-Free Formation and Reorganization Rules

If the installment method is not available, the buyer is a corporation and a corporate departing shareholder is willing to accept stock in the buyer or if the buyer wants to acquire the entire business but the other owners do not want to dispose of their investment, the corporate reorganization rules (alone or in combination with Code Section 351 tax-free incorporation rules) may be used to accomplish the goals of the parties. For example, suppose that the departing shareholder (A) locates a buyer (P Corp.) who desires to obtain the entire business (T). If P Corp. wants to obtain the entire business, but keep it separate from P’s business, A wants to cash out, and the remaining owners are willing to continue their ownership interest in T via ownership of P stock, then the transaction can be cast in the following form:

(1) P forms new subsidiary S by transferring to S in exchange for S stock sufficient P stock (whether common or preferred, voting or nonvoting) to compensate the remaining T shareholders for their T stock and sufficient cash or other

46. I.R.C. § 453(b)(1)-(2). Under the installment method, gain on installment sales is recognized as payments are received. I.R.C. § 453(h)(1)(A). For instance, when the taxpayer receives annual payments equal to 20% of the total selling price, the taxpayer must report 20% of the gain recognized on the sale. Id.
47. I.R.C. § 453(f)(4)-(5) (discussing treatment of notes payable on demand, issued by third parties or readily tradable); I.R.C. § 453(f) (discussing treatment of notes sold by dealers in stock).
non-P-stock consideration (including an installment note) to compensate A for his T stock;
(2) T merges into S in a statutory merger, with the remaining T shareholders receiving P stock and A receiving the cash or other non-P-stock consideration.

This transaction should qualify as a tax-free forward subsidiary merger as long as A cashes in T stock constituting no more than fifty percent of the value of T.\(^ {48}\) It is critical to avoid using S stock in this transaction or it will fail to qualify as a tax-free reorganization.\(^ {49}\)

If A owns more than fifty percent of the corporation's outstanding stock and A is unwilling to accept P stock, Section 351 may be used. Under Section 351 the remaining shareholders and P form a new corporation (Newco). The remaining shareholders would contribute their T stock and consideration acceptable to the departing shareholder, respectively, in exchange for Newco stock. Then the departing shareholder would be cashed out in a merger of T and Newco. This would

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48. The IRS requires that at least 50% of the outstanding T stock be exchanged for P stock. See Rev. Proc. 77-37, §3.02, 1977-2 C.B. 568. Courts have been more lenient, permitting as little as 16% of the T stock to be exchanged for P stock in a valid tax-free reorganization, but attorneys practicing in the area tend to draw the line at 40% T stock continuity. See MARTIN D. GINSBURG & JACK S. LEVIN, Mergers, Acquisitions and Buyouts: A Transactional Analysis of the Governing Tax, Legal and Accounting Considerations, § 610.3 (July 1996). If A owns more than 50% or 60% of the T stock, this transaction will qualify as a tax-free reorganization only if A is willing to accept enough P stock, which could include income-producing preferred stock, so that at least 50% of the total consideration for the T stock is made up of P stock.

49. If the parties desire to keep T alive by merging S into T in a reverse subsidiary merger, they may do so in a tax-free reorganization if (1) P exchanges non-P-voting-stock consideration for no more than 20% of the T voting stock and 20% of the shares of each other class of T stock (with any remaining non-P-voting-stock consideration coming from T, the remaining T shareholders or the P shareholders), and (2) T retains substantially all of its assets and the assets of S (counting any T assets used to redeem some or all of A's stock but not including P assets transferred by S as consideration for T stock). See I.R.C. § 368(a)(2)(E); Treas. Reg. § 1.368-2(j)(3)(iii).

In the alternative, the same result may be obtained through a redemption of A by T followed by an exchange of the remaining T stock solely for voting stock of P. See I.R.C. § 368(a)(1)(B). Care must be taken in this transaction to avoid using any P consideration other than voting stock. If it is not feasible to fund A's redemption with T assets, A's stock may be purchased by remaining T shareholders or by P shareholders, or P may make a bona fide loan to T for the purpose of redeeming A's shares. See GINSBURG & LEVIN, supra note 48, at §§ 701.5, 701.4 (July 1996) (generally distinguishing between payments from the acquiring corporation, which are prohibited in the context of section 368(a)(1)(B) reorganizations, and payments from other sources).
leave P and the remaining shareholders as owners of T or T's successor.\textsuperscript{50}

\textit{f. Avoidance of Gain on Stock Held Until Death}

Any shareholder contemplating a sale of stock should be apprised of the significant tax benefit she will forego if she disposes of the stock prior to death. Were she instead to dispose of the stock by bequest after death, the stock would take a basis in the hands of her heirs equal to its fair market value as of the date of death,\textsuperscript{51} thereby eliminating any untaxed gain in the stock at that time.\textsuperscript{52}

3. \textit{Loss Rules}

A shareholder who sells her stock in a C corporation recognizes a loss to the extent her adjusted basis in the stock exceeds the amount realized.\textsuperscript{53} Generally, losses on corporate stock or debt evidenced by a security must be taken as a capital loss when the stock or security is sold or becomes worthless.\textsuperscript{54} However, an individual may treat certain stock losses as ordinary losses if the requirements of Section 1244 are met.\textsuperscript{55} These requirements include: (a) the stock must be issued for money or property,\textsuperscript{56} (b) the corporation must initially be capitalized in an amount no greater than one million dollars,\textsuperscript{57} (c) the corporation must have derived more than fifty percent of its gross receipts in the five years prior to the year of the loss from sources other than passive income such as interest, rents and dividends,\textsuperscript{58} and (d) individual aggregate ordinary losses deducted under Section 1244 may not exceed fifty thousand dollars annually.\textsuperscript{59}

\begin{footnotesize}
\begin{enumerate}
\item GINSBURG \& LEVIN, \textit{supra}, note 48, at § 901.
\item I.R.C. § 1014(a)(1).
\item Since gain equals the amount realized on a disposition of property (which usually will be equal to its fair market value) minus adjusted basis, I.R.C. § 1001(a), stepping up the basis of property to fair market value eliminates any untaxed gain.
\item I.R.C. § 1001(a), (c).
\item I.R.C. §§ 1211(b), 1221.
\item I.R.C. § 1244(a).
\item I.R.C. § 1244(c)(1)(B).
\item I.R.C. § 1244(c)(1)(A), (c)(3).
\item I.R.C. § 1244(c)(1)(C), (c)(2).
\end{enumerate}
\end{footnotesize}
B. Complete Redemption

A redemption of stock in a C corporation will be taxed in one of two ways—either as a distribution taxable under Section 301 or as a sale or exchange of stock.\(^60\) In either case, the redemption may be taxable at both the corporation and shareholder levels.\(^61\) However, only a distribution taxable under Section 301 will, to the extent of the corporation’s earnings and profits, be fully included in the shareholder’s income and taxed at the higher ordinary income rates.\(^62\) Sale or exchange treatment is superior to this “dividend” treatment in that: (1) the shareholder’s stock basis will reduce the amount of the redemption proceeds that are taxable; (2) the lower capital gains rate may apply; and (3) the installment method may be available to defer taxation of payments stretched out over time.\(^63\) In general, complete redemptions of all the departing shareholder’s stock are treated as taxable exchanges, as detailed below.\(^64\)

1. Shareholder Treatment—Redemption Taxable As Sale

   a. Taxable Sale Rules

A complete redemption will be treated essentially as a sale of stock by the shareholder.\(^65\) The distribution will be a tax-free return of capital to the extent of the shareholder’s basis in the stock. Any portion of the amount realized\(^66\) on the distri-

\(^60\) I.R.C. §§ 301(a), 302(a).

\(^61\) I.R.C. §§ 301(c), 1001, 311(b).

\(^62\) I.R.C. §§ 301(c)(1), 316(a).

\(^63\) See I.R.C. §§ 1001, 1(h), 1222, 1221, 455. Note, however, that in no event will the remaining shareholder be allowed to deduct a loss on the stock until he or she sells to a third party, completely disposes of the stock via redemption or abandonment, or determines that the stock is wholly worthless. Treas. Reg. §§ 1.165-4(a), 1.165-5(d); 1.1001-1(c)(1).

\(^64\) I.R.C. § 302(a), (b)(3). In determining whether there has been a complete redemption, both the stock actually owned by the shareholder and stock constructively owned under the § 318 attribution rules must be taken into account. I.R.C. § 302(c)(1).

\(^65\) “If a corporation redeems its stock . . . and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.” I.R.C. § 302(a). Subsection (a) applies “if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.” I.R.C. § 302(b)(3).

\(^66\) The amount of the distribution equals the cash plus fair market value of any property received minus any liabilities of the corporation assumed by the shareholder.
b. Opportunities To Exclude or Defer Shareholder Gain

The opportunities for excluding or deferring taxable gain on a redemption of stock are generally similar to those available upon a sale to a third party or a remaining owner, as detailed above. However, there is a difference in the rules that apply to transfers between spouses.

When spouses-shareholders get a divorce, it may not be possible or desirable for the departing spouse to transfer or sell his or her interest to the remaining spouse. The remaining spouse may not have the resources to make such a purchase, and the departing spouse may be unwilling to transfer the interest without consideration or in exchange for a promissory note from the remaining spouse. The other remaining owners may wish to minimize dilution of their interests. Finally, the parties may want to have the tax consequences of redemption fall on the departing spouse—a particularly attractive alternative if the departing spouse will completely redeem and can therefore (1) take advantage of the complete redemption test to avoid dividend treatment; and (2) deduct any loss on the stock.

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(or to which distributed property is subject) in connection with the distribution. Treas. Reg. § 1.1001-1(a) (amount realized (AR) equals the sum of any money received plus the fair market value (FMV) of any property received); cf. I.R.C. § 301(b)(1), (2); Treas. Reg. §1.301-1(g) (reducing the amount of any § 301 distribution by the amount of corporate liabilities assumed by the shareholder or to which the distributed property is subject).

67. I.R.C. § 1001. Character will be determined by the character of the stock in the shareholder’s hands, which will often be capital. See I.R.C. § 1221.

68. I.R.C. § 1012.

69. See supra Part IIIA. These opportunities include the 50% exclusion of gain on certain small business stock under I.R.C. § 1202, deferral of gain on sale to a spouse or former spouse under I.R.C. § 1041, deferral of gain by use of an installment sale under I.R.C. § 453, and avoidance of gain by holding the stock until death to take advantage of stepped up basis at death under I.R.C. § 1014(a)(1).

70. In theory, I.R.C. § 1041 should permit the parties to allocate the tax liability on the transaction between themselves. If the remaining spouse receives the departing spouse’s interest in a transfer or exchange, the remaining spouse will eventually be taxed on any disposition of the interest. However, the departing spouse should generally pay the tax if he or she redeems his or her interest or sells it to a third party. The shift in
In any such case, the divorcing parties may prefer to forego the transfer from the departing spouse to the remaining spouse and have the business redeem the interest of the departing spouse directly.\textsuperscript{71} Outside the divorce context, such a redemption would be a taxable event for the departing spouse and would have no tax consequences for the remaining spouse or other remaining shareholders.\textsuperscript{72} However, a redemption incident to divorce may have unexpected consequences for both spouses—the possibility of Section 1041 nonrecognition for the departing spouse and the possibility of a constructive dividend or distribution for the remaining spouse and, conceivably, other remaining shareholders.\textsuperscript{73} Obviously, if the parties choose redemption of the departing spouse expressly to allocate the tax on the business interest to that spouse, such a result would defeat their aims.

\textit{Arnes v. Commissioner} (Arnes I) involved spouses who were joint and sole shareholders of a closely held corporation that owned and operated a McDonald’s franchise in Washington, a community property state.\textsuperscript{74} In a written property settlement, John Arnes agreed that the corporation would redeem Joann Arnes’ stock interest in exchange for forgiveness of a debt she owed the corporation and certain deferred cash payments. John guarantied the corporation’s deferred payment obligations in the divorce agreement. The Ninth Circuit held that the redemption by Joann was “for the benefit” of John because he could be sued on his guaranty and because certain of his marital obligations under state law were discharged as a result of the redemption.\textsuperscript{75} The parties were treated as if Joann had first transferred her stock to John tax-free under I.R.C. Section 1041 and John had

\begin{footnotesize}
\begin{enumerate}
\item[71.] Alternatively, the departing spouse could sell his or her interest to a third party. In that event, the departing spouse would be taxed on the excess of the sale proceeds over basis in the interest, possibly at favorable capital gains rates. \textit{See generally supra} Part III.A.1.
\item[72.] \textit{See generally supra} Part III.B.a.
\item[74.] 981 F.2d 456 (9th Cir. 1992), \textit{aff'd} 91-1 USTC \$ 50,207 (W.D. Wash. 1991).
\item[75.] The Ninth Circuit applied Temporary Treasury Regulation § 1.1041-1T(c) (Q&A-9). \textit{Arnes}, 981 F.2d 456 at 460.
\end{enumerate}
\end{footnotesize}
then redeemed the stock in a taxable transaction.\textsuperscript{76}

c. Loss Rules

In general, a shareholder who redeems her stock in a C corporation may recognize any loss in the same manner, and of the same character (including the opportunity for ordinary loss treatment under Section 1244), as in the context of a sale of stock to a third party or remaining owner.

2. Shareholder Treatment—Redemption Taxable As a Section 301 Distribution

In the redemption context, the attribution rules of Section 318 pose a potential tax problem for the departing shareholder.\textsuperscript{77} When it is necessary to determine how much stock a shareholder owns (e.g., to determine whether a complete redemption has occurred), attribution rules may apply to attribute to the shareholder ownership in stock held by other persons or entities.\textsuperscript{78} If the redeeming shareholder continues to own stock by attribution after a complete redemption of the stock he or she actually owns, then the redemption may be taxed as a distribution under Section 301 rather than as an exchange.\textsuperscript{79} To the extent of the corporation's earnings and

\textsuperscript{76} In a subsequent case involving the tax consequences of this transaction for the remaining spouse, John Arnes, the Tax Court refused to recharacterize the redemption as a constructive dividend on the ground John Arnes did not have a primary and unconditional obligation to purchase Joann's stock. Arnes, 102 T.C. 522 (1994); see also infra part III.B.3.


\textsuperscript{78} I.R.C. §§ 302(c)(1), 318. For instance, ownership of stock by a parent will be attributed to her child and ownership of stock by a corporation will be attributed to any shareholder owning at least 50% of the corporation's stock. I.R.C. §§ 318(a)(1)(A)(ii), (2)(C). In the latter situation, the shareholder will be deemed to own her ratable share of the stock owned by the corporation (e.g., ownership of 15% of the stock will be attributed to a 75% shareholder).

\textsuperscript{79} I.R.C. § 302(a), (b)(3). A partial redemption may be taxed under the preferable exchange rules if it meets either of the § 302(b)(1) or 302(b)(2) tests. See generally infra notes 91-93 and accompanying text.
profits (E&P)\textsuperscript{80} at the time of the distribution, any such distribution will be fully taxable at the shareholder’s ordinary income rate.\textsuperscript{81} Obviously, this result is far less desirable than exchange treatment.\textsuperscript{82}

If a shareholder desires a complete redemption, and the shareholder’s spouse, parent, child, or grandchild will continue to own stock in the corporation, then the shareholder may waive family attribution.\textsuperscript{83} Attribution to or from an entity may not be waived.\textsuperscript{84} Family attribution will be waived if:

(i) immediately after the distribution [in redemption] the [redeeming shareholder] has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor, (ii) the [redeeming shareholder] does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of [the distribution in redemption], and (iii) the [redeeming shareholder] . . . files an agreement to notify the [Internal Revenue Service] of any acquisition described in clause (ii) and to retain such records as may be necessary . . . .\textsuperscript{85}

\textsuperscript{80} The E&P account is a tax concept used to measure the undistributed profits of a C corporation for purposes of determining whether a distribution to shareholders should be treated as a taxable distribution of corporate profit (i.e., an ordinary income dividend). Because its purpose is roughly to account for economic, rather than taxable, income, the E&P account can include items not taken into account for tax purposes (like tax-exempt interest) and exclude items that are taken into account for tax purposes (like accelerated depreciation). E&P must be adjusted for corporate income, loss and distributions to shareholders.

\textsuperscript{81} I.R.C. §§ 301(c)(1), 316(a). The shareholder takes a fair market value basis in property received in a distribution. I.R.C. § 301(d).

\textsuperscript{82} Note, however, that a shareholder redeeming only a portion of his stock from a corporation without E&P may be better off under the § 301 distribution rules than under the exchange rules. Whereas exchange treatment requires allocation of basis among the redeemed and nonredeemed shares, § 301 distributions are tax-free to the extent of the shareholder’s entire stock basis. See I.R.C. § 301(c)(2); Treas. Reg. §§ 1.61-6(a), 1.1012-1(c). Moreover, if the redeeming shareholder is a corporation, then dividend treatment is preferable to the extent the corporate shareholder is entitled to a dividend’s received deduction (DRD). I.R.C. § 245. This article addresses issues relating only to individual shareholders.

\textsuperscript{83} I.R.C. § 302(c)(2).

\textsuperscript{84} See Rickey v. United States, 592 F.2d 1251, 1257 (5th Cir. 1979) (holding that entity attribution rules may not be waived). Since Rickey, Congress has modified § 302(c)(2) to provide for the waiver of family attribution by an entity where family attribution supplies an essential link in a chain of attribution leading to the entity. I.R.C. § 302(c)(2)(C). Nonetheless, it remains the case that entity attribution may not be waived.

\textsuperscript{85} I.R.C. § 302(c)(2)(A) (emphasis added). Courts disagree as to the meaning of “interest other than as a creditor.” The Tax Court has taken the position that a
However, waiver of family attribution is unavailable in certain circumstances involving transfers between family members within ten years before the redemption, if either the transfer or the redemption has tax avoidance as a principal purpose.\textsuperscript{86}

If the departing shareholder cannot completely terminate her interest, she may nonetheless be taxed under the relatively favorable exchange rules if the redemption is either not essentially equivalent to a dividend, or is a substantially dispro-

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former shareholder who performs services for the corporation does not have a prohibited interest as long as the former shareholder does not have either a financial stake in or continued control over the corporation. Lynch v. Commissioner, 83 T.C. 697 (1984) (holding redeemed shareholder earning $500 per month as an independent contractor under a consulting contract with the redeeming corporation did not hold a prohibited interest), rev'd, 801 F.2d 1176 (9th Cir. 1986); see also Cerone v. Commissioner, 87 T.C. 1 (1986) (applying the facts and circumstances "financial stakes" or "control test" in holding that a redeemed shareholder working as an employee for the redeeming corporation for at least five years following the redemption and earning $14,400 per year during the first three of those years did hold a prohibited interest); Seda v. Commissioner, 82 T.C. 484 (1984) (applying a facts and circumstances "financial stakes" or "control test" in holding that a redeemed shareholder working as an employee for the redeeming corporation for two years following the redemption and earning $1,000 per month did hold a prohibited interest); Estate of Lennard v. Commissioner, 61 T.C. 554 (1974) (holding that a former shareholder providing accounting services for the redeeming corporation as an independent contractor did not have a prohibited interest, suggesting "financial stake" requires an equity-like interest in the corporation). But see Lynch v. Commissioner, 801 F.2d 1176 (9th Cir. 1986) (holding "a taxpayer who provides post-redemption services, either as an employee or an independent contractor, holds a prohibited interest in the corporation because he is not a creditor.")

Another area in which a redeeming shareholder who must waive family attribution may run into a prohibited interest problem is when the corporation will make deferred redemption payments and the redeemed shareholder takes steps to protect his credit interest. In that event, certain protections may cross the line into prohibited interest territory. For instance, appointment of an agent to sit on the corporation's board of directors solely to protect the credit interest of the redeemed shareholder constitutes a prohibited interest in the view of the IRS. Rev. Rul. 59-119, 1959-1 C.B. 68. In general, the rights of the redeemed shareholder must not be greater than necessary to enforce his claim against the corporation. Treas. Reg. § 1.302-4(d); see also Rev. Proc. 88-22, 1988-1 C.B. 680 (providing ruling guidelines on installment redemptions). The courts are more lenient. See Dunn v. Commissioner, 615 F.2d 578 (2d Cir. 1980) (postponement of payments due redeemed shareholder in favor of restrictions in corporation's franchise agreement did not create equity-like interest); Estate of Lennard v. Commissioner, 61 T.C. 554 (1974), nonacq. 1978-2 C.B. 9 (subordinated demand note not an equity-like interest); Lisle v. Commissioner, 85 T.C.M. 627 (1976) (20-year payment period, retention of voting rights under a security agreement and retention of director and officer positions did not amount to a prohibited interest in particular circumstances presented).

portionate redemption. A redemption is not essentially equivalent to a dividend if, in light of the relevant facts and circumstances, the redeeming shareholder experiences a meaningful reduction in proportionate ownership interest (e.g., loses majority control) as a result of the redemption. A shareholder’s ownership interest includes rights with respect to voting, distributions, and assets in liquidation. However, the Service seems to place greater significance on reductions in voting control in determining whether the shareholder has experienced a meaningful reduction.

A substantially disproportionate redemption is also taxed as an exchange. A redemption meets this mechanical test if, immediately after the redemption, the shareholder holds: (1) less than fifty percent of the corporation’s voting stock; (2) less than eighty percent of her previous voting interest; and (3) less than eighty percent of her previous common stock interest. Qualification under this test will not save a redemption that is part of a series of redemptions pursuant to a plan intending or resulting in an aggregate distribution that is not substantially disproportionate.

87. I.R.C. § 302(a), (b)(1), (b)(2).
88. United States v. Davis, 397 U.S. 301 (1970), reh’g denied, 391 U.S. 1071 (1970) (holding redemption of stock from a sole shareholder is essentially equivalent to a dividend); see also Rev. Rul. 85-106, 1985-2 C.B. 116 (holding that the redemption of nonvoting preferred stock does not qualify as a §302(b)(1) redemption when there is no reduction in the redeeming shareholder’s percentage of voting stock, and the shareholder still has an undiminished opportunity to act in concert with other shareholders as a control group.); Rev. Rul. 78-401, 1978-2 C.B. 127 (reduction of interest from 90% to 60% was not meaningful); Rev. Rul. 77-218, 1977-1 C.B. 81 (reduction leaving shareholders with more than 50% voting control was not meaningful); Rev. Rul. 76-364, 1976-2 C.B. 91 (reduction of interest from 27% to 22% was meaningful); Rev. Rul. 75-502, 1975-2 C.B. 111 (reduction of interest from 57% to 50% was not meaningful where other shareholder unrelated); Rev. Rul. 56-183, 1956-1 C.B. 161 (reduction of interest from 11% to 9% was meaningful).
90. See Rev. Rul. 85-106, 1985-2 C.B. 116 (holding that a redemption of nonvoting preferred stock by a shareholder who also owned voting common stock was not a meaningful reduction because there was not a reduction in voting power). But see Rev. Rul. 77-426, 1977-2 C.B. 87 (holding that a shareholder holding no stock other than nonvoting preferred may redeem a significant portion of such stock in a redemption not essentially equivalent to a dividend).
91. I.R.C. § 302(b)(2).
3. Risk of Dividend to Remaining Shareholder

If a corporation redeems stock that a remaining shareholder was primarily and unconditionally obligated to purchase (i.e., under a shareholder buy-sell agreement), the remaining shareholder may be treated as receiving a constructive distribution in the amount of the redemption proceeds. For instance, in Sullivan v. United States, the court held that a remaining shareholder who was unconditionally obligated under the terms of a management agreement to purchase stock of a shareholder-manager upon termination of the manager's employment received a constructive dividend when the corporation purchased the manager's stock. A shareholder with a primary and unconditional obligation to purchase stock of another shareholder may assign such obligation to the corporation without tax consequence if he does so while the obligation is still contingent (i.e., prior to the occurrence of a triggering event provided in a buy-sell agreement).

Although the weight of authority relies on the primary and unconditional obligation test, caution should be exercised in relying on that test. The Ninth Circuit recently applied a broader "economic benefit" test to determine whether a redemption by one shareholder should be recharacterized as a constructive distribution to the remaining shareholder.

94. Such a distribution will be taxable as an ordinary income dividend to the extent of the corporation's earnings and profits. I.R.C. §§ 301(c)(1), 316(a).
96. 368 F.2d 724 (8th Cir. 1966).
97. Id. at 728-29.
98. Rev. Rul. 69-608, 1969-2 C.B. 43. Typical triggering events include death, disability and retirement of a shareholder. Obligations to purchase stock of another shareholder can be created in contracts other than shareholders' agreements, such as employment contracts, divorce agreements and franchise agreements.
99. See supra notes 96-98.
100. See supra Part III.B.1.b. (discussing Arnex v. United States, 981 F.2d 456 (9th Cir. 1992) (holding a shareholder redeeming her stock pursuant to a divorce agreement was entitled to nonrecognition for transfers between spouses under § 1041 on the theory the redemption provided an "economic benefit" to the remaining spouse)).
In order to preserve flexibility without creating constructive dividends to remaining shareholders, buy-sell provisions should be drafted to avoid saddling either shareholders or the corporation with primary and unconditional purchase obligations when a triggering event occurs. This can be done by obligating remaining shareholders to purchase only in the event the corporation does not do so or by giving the corporation and remaining shareholders options or rights of first refusal upon the occurrence of a triggering event.  

4. Corporation Treatment

Turning to the tax consequences of the C corporation upon a redemption of its stock, it must first be noted that corporations are not allowed any deduction for distributions to shareholders with respect to their stock. Moreover, a corporation distributing appreciated property will be taxed on its gain in the property as of the time of the distribution.  


102. I.R.C. § 312(b).

103. I.R.C. §§ 312(b)(1), 312(n)(7).

104. I.R.C. § 311(a). The combination of disallowing a loss to the corporation on the distribution of property worth less than the corporation’s basis and granting the shareholder a fair market value basis in the property, has the effect of causing the corporation’s loss, with respect to the property, to disappear without being taken into account for tax purposes. See supra Part III.B.1.a, III.B.2. For instance, suppose that C Corporation owns property with a fair market value of $200,000 and tax basis of $250,000. If C were to sell the property to an unrelated third party, it would be allowed to deduct the loss of $50,000 (subject to various limitations not relevant here). If, however, C Corporation distributes the loss property to a shareholder, § 311(a) will prevent C from taking any loss deduction. Since the departing shareholder will take a basis in the property equal to fair market value, or $200,000, C Corporation’s $50,000 built-in loss will vanish.

105. I.R.C. § 312(a)(3).
If the shareholder is deemed to receive an ordinary income dividend, then the tax treatment of the redeeming corporation is very similar to that of a corporation making a distribution taxable as an exchange. However, the redeeming corporation must reduce its E&P, to the extent thereof, by the amount of any cash and the fair market value of any appreciated property distributed\textsuperscript{106} rather than by the share of E&P allocable to the redeemed shares. Since the E&P reduction may therefore be greater for a Section 301 distribution than for a redemption taxable as an exchange, remaining owners may prefer Section 301 treatment because it will reduce the amount of future distributions taxable as ordinary income dividends.

5. Financing Issues

a. Insurance

Buy-outs by the corporation or remaining shareholders may be financed with a combination of life insurance and lump-sum disability insurance. Insurance proceeds are generally excluded from taxable income of the shareholders.\textsuperscript{107} While the corporation may also exclude such insurance proceeds for regular tax purposes,\textsuperscript{108} insurance proceeds are included in "adjusted current earnings" for purposes of computing alternative minimum tax (AMT) liability.\textsuperscript{109} Therefore, the receipt of insurance proceeds may create or contribute to an AMT liability for the corporation. For this reason, it may be preferable for shareholders to agree to a cross-purchase arrangement\textsuperscript{110} for events covered by insurance (e.g., death or disability) but to avoid any mandatory cross-purchase in any situation in which the shareholders may need to use corporate resources to fund the buy-out (e.g., retirement or divorce).\textsuperscript{111}

\textsuperscript{106} I.R.C. § 312(a), (b). Note that E&P is reduced by the corporation's basis in any depreciated property distributed in a redemption taxable as a § 301 distribution. I.R.C. § 312(a)(3).
\textsuperscript{107} I.R.C. §§ 101, 104-06.
\textsuperscript{108} I.R.C. §§ 101, 104-06.
\textsuperscript{109} I.R.C. § 56(g)(4)(B)(ii); see BERI ABBIN ET AL., CORPORATE ALTERNATIVE MINIMUM TAX (CCH Tax Transactions Library, 1992) (discussing the highly technical computation of adjusted current earnings).
\textsuperscript{110} Under a cross-purchase agreement the shareholders purchase stock from each other rather than having the corporation redeem the stock.
\textsuperscript{111} If the corporation relieves the remaining shareholder(s) of an obligation to purchase stock when it redeems the stock of the departing shareholder, the remaining
b. **Debt**

A corporation may prefer to borrow funds needed to redeem a departing shareholder, or issue an installment note to the departing shareholder, rather than trigger taxable gain by either selling or distributing appreciated property.

C. **Comparison of Structuring Alternatives**

In general, there are a number of important similarities in the tax treatment of sales and redemptions of C corporation stock. Each is generally treated as a taxable sale from the departing shareholder’s standpoint; recognized gains and losses are determined by taking the shareholder’s stock basis into account and are likely to be capital in character (although each structure may give rise to ordinary losses under Section 1244). Moreover, each structure offers opportunities to avoid or defer gain in limited circumstances (under the fifty percent exclusion for certain small business stock, the nonrecognition of gain on sales to spouses or ESOPs and the deferral of gain under the installment method). Nonetheless, there are also a number of important differences that should be taken into account in any buy-sell agreement among C corporation shareholders as well as by any departing shareholder.

The first important difference is that only redemptions carry the potential for immediate double taxation if appreciated property is used, or sold, to provide redemption proceeds. Immediate taxation of corporate-level gain will reduce the present value of the redeeming shareholder’s interest (unless the corporation would have paid tax on such gain in the near future anyway).\(^{112}\) Additionally, only redemptions carry the risk of ordinary-income dividend treatment for both the departing owner\(^ {113}\) and for remaining owners.\(^ {114}\)

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shareholder may be treated as having received a constructive dividend. *See supra* Part III.B.3.

112. Although the purchase price of stock sold to a third party or remaining owners should be discounted to take into account eventual corporate-level taxation of the business’s appreciated assets, the present value of such tax will be lower, and the purchase price effect diminished, to the extent the tax can be deferred.

113. Risk to the departing owner occurs if there is continuing constructive ownership. *See supra* Part III.B.2.

114. Risk to the remaining owners occurs if the redemption discharges a primary and unconditional obligation of a remaining owner to purchase the stock of the
The structuring choice need not be viewed as an either/or decision. In some circumstances, the departing shareholder may be well advised to sell a portion of her stock and redeem the rest. For instance, there may be assets that the business no longer wants or needs that could be used to finance a partial redemption. In the alternative, a third party buyer and other remaining owners may wish to reduce the corporation's E&P to minimize future ordinary income dividends. In these circumstances, the order in which the steps are taken (partial sale followed by redemption or vice versa) should not matter as long as both steps are part of an overall plan to completely terminate the interest of the departing shareholder.115

IV. DEPARTING OWNER IS A SUBCHAPTER S SHAREHOLDER

A. Sale To a Third Party or Remaining Owner

Like a sale of C corporation stock, a sale of S corporation stock is generally taxed as a sale or exchange of property.116
The sale triggers a tax gain or loss measured by comparing sale proceeds to the seller's stock basis. For most shareholders, the Subchapter S stock will be a capital asset subject to the preferential capital gains rate if it is held more than one year. Finally, the departing shareholder takes a cost basis in any property received as consideration in the transaction.

Shareholder deferral opportunities are more limited in the S corporation context. The good news is that the installment method may be available to defer the seller's gain, and a sale between spouses is tax-free. Moreover, a Subchapter S stock disposition can be structured to defer gain under Section 351 and the tax-free reorganization provisions so long as care is taken to avoid terminating the corporation's qualification as an S corporation. Stepped up basis at death applies equally to all forms of property, including S corporation stock. However, unlike a sale of C corporation stock, neither the ESOP tax benefits nor the fifty percent exclusion for gain on dispositions of certain small business stock is available to a shareholder when she sells her S corporation stock.

The flowthrough nature of the S corporation creates a number of special issues that must be considered when structuring a departure transaction. In general, S corporations are not taxpayers; instead S corporation tax items are allocated among the shareholders, who report the items on their individual

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would be the case if the business were operated as a C corporation. This discrepancy
is attributable to the stock basis adjustments triggered by the annual flowthrough of S
corporation tax items to its shareholders. See infra this Part IV.A. and accompanying
notes.

118. I.R.C. §§ 1(h), 1221, 1222. However, a sale of stock may give rise to an
ordinary loss under § 1244. See supra Part III.A.3.
119. I.R.C. § 1012.
120. I.R.C. § 453; see supra Part III.A.2d (discussing the limitations on application of
the installment method).
121. I.R.C. § 1041(a); see supra Part III.A.2.b (discussing § 1041).
122. For instance, an S corporation may not have corporate shareholders. See I.R.C.
§ 1561(b)(1)(B); see also Ginsburg & Levin, supra note 48, at §§ 1106, 1107, 1110, 1111
(discussing of tax-free reorganizations to which an S corporation is a party).
123. I.R.C. § 1014(a)(1).
124. See I.R.C. § 1202(a), (d)(1) (limiting the 50% exclusion to dispositions of stock
in a "qualified small business" and limiting such status to C corporations); Announcement
75-190, 1975 I.R.B. 16 (explaining that S corporations may not establish ESOPs
because a trust may not own stock of a Subchapter S corporation under I.R.C.
§ 1571(a)(2)).
returns.\footnote{I.R.C. \textsection{} 1366(a)(1), (c).} These allocations are matched by stock basis adjustments intended to prevent double taxation of the S corporation business.\footnote{I.R.C. \textsection{} 1367(a)(1)(A)-(C), (a)(2)(B)-(D) (requiring that stock basis be increased for items of income or decreased for items of deduction or loss allocated to the shareholder under I.R.C. \textsection{} 1366(a)(1)); 1368(b)(1), (c)(1) which allow tax-free distributions to the extent of the shareholder's adjusted stock basis).} It follows that, in order to calculate gain or loss on a sale of S corporation stock, the departing shareholder's tax allocations and any distributions from the corporation for the year of the sale must be taken into account and stock basis adjusted.\footnote{For purposes of allocating S corporation tax items, the shareholders must determine whether to elect to close the corporation's books as of the date of the sale or fall back on the daily pro rata method of allocating tax items. See I.R.C. \textsection{} 1377(a)(2) (providing for an election to close the corporation's books with the consent of all shareholders during the taxable year). An election to close the corporation's books may be made in the event of termination of a shareholder's entire interest or disposition by one shareholder of at least 20\% of the corporation's outstanding stock within a 30-day period. Treas. Reg. \textsection{} 1.1368-1(g)(2)(i)(A). However, under proposed regulations, the closing of the books method would be available only upon complete termination of a shareholder's interest. Prop. Reg. 1.1377-1(b)(1), 60 Fed. Reg. 35882, 35884-85 (1995) (to be codified at 26 C.F.R. Pt. 1) (proposed July 12, 1995). In the absence of an election, the S corporation's tax items are allocated equally over the days of the year, and then each day's allocation is pro rated among the shares of stock outstanding on that day. Prop. Reg. \textsection{} 1.1377-1(a)(1), (c)(Ex. 1 and 2), 60 Fed. Reg. 35882, 35884-85 (1995) (to be codified at 26 C.F.R. Pt. 1) (proposed July 12, 1995). If the departing shareholder terminates her interest before the end of a year, this method may have the effect of shifting income or loss between the departing shareholder and other shareholders. Some income or loss will shift from the period in which the income was actually earned or received to the other period, unless actual income or loss falls proportionately within the periods. By contrast, electing to close the corporation's books ensures that the income allocated to the seller and buyer will correspond to the income actually earned or received during their respective periods of ownership. If the timing of the S corporation's income and losses for the year is uncertain, it will not be clear at the time of the sale which party will benefit and which will be hurt by any misallocation of income caused by application of the daily pro rata method. Therefore, risk may be reduced for all parties by agreeing at the time of the sale to elect the closing-of-the-books method. In addition, it may be prudent to include a tax indemnification provision in the purchase agreement providing for grossed-up reimbursement payments by any party whose tax liability is shifted to the other if such shift is not reflected in the purchase price or otherwise taken into account in negotiating the terms of the sale. See Stephen R. Looney, \textit{Section 1377 Prop. Regs. Clarify Pro Rata Share Rules and Post-Termination Transition Period}, 88 J. TAX'N 335, 335-40 (1995) (discussing the closing of the books method election).} Because of the corresponding basis adjustments, such tax item allocations should not, in theory, change the total net income or loss to be reported by the departing shareholder.
for the tax year of the departure transaction. However, to the extent ordinary income allocations reduce capital gain from the stock disposition, the shareholder's tax bill for the year of departure will be higher than if the S corporation's ordinary income were somehow deferred to a later year.

Furthermore, the stock basis adjustment mechanism for preventing double taxation affords only rough justice when a departing shareholder recognizes taxable stock gain attributable to as yet untaxed income of the business (e.g., from unrealized receivables or appreciated real estate). In addition to the departing shareholder's tax on such stock gain, a second tax may be imposed when the buyer is eventually allocated her share of such income (e.g., when the receivables are paid or the real estate is sold). Although the second tax will be offset by an

128. For instance, suppose S Corporation generates $300,000 of net ordinary operating income in the year departing shareholder D sells her 50% stock interest to buyer B for $500,000. The sale takes place on a date falling exactly mid-way through the year (which includes a Leap Day to even out the number of days to 366). D's basis in the stock as of the beginning of the year is $400,000. Income of $200,000 is generated in the first half of the year and $100,000 is generated in the second half of the year. Under the daily pro rata method, $75,000 of S Corporation's $300,000 income for the year of sale will be allocated to each of D and B because each owns one-half of the stock for one-half of the year. The allocation will increase D's stock basis to $475,000, thereby reducing the gain on the sale of her stock to B to $25,000. Her total S Corporation income for the year will be $100,000 ($75,000 ordinary operating income plus $25,000 stock capital gain). By contrast, under the closing of the books method, D will be allocated $100,000 of the S Corporation operating income (one-half of the actual income for the first half of the year) and B will be allocated $50,000 (one-half of the actual income for the second half of the year). D's stock basis will be increased to $500,000, and she will realize no gain on the sale of her stock for $500,000. D's total S Corporation income for the year will be $100,000 (all ordinary income). In either case, D's total income is $100,000; however, the character of that income is affected by the choice of income allocation method. See Prop. Reg. § 1.1377-1(c), 60 Fed. Reg. 35882, 35884-85 (1995) (to be codified at 26 C.F.R. Pt. 1) (proposed July 12, 1995), for additional examples.

129. See example in note 128, supra. Worse yet, ordinary income allocations may increase stock basis so as to create a capital loss on the redemption. In the example above, in footnote 128, allocation to D of more than $100,000 of S Corporation operating income would have caused her stock basis to increase above the $500,000 stock sale price, thereby creating a capital loss on the sale of the stock. Since individuals may deduct only $3,000 of capital losses against ordinary income in a taxable year, D's stock loss would not, for the most part, be deductible against the ordinary S Corporation income. I.R.C. §§ 1211(b), 1212(b)(1).

130. The fact that tax has already been paid with respect to the buyer's portion of such income is reflected in the buyer's cost basis in her stock but is not reflected in the corporation's basis in its assets. Hence, the second tax on the same income. Similar "double tax" problems can arise in the partnership context, but can be avoided by
eventual capital loss created by the corresponding basis increase in the buyer’s stock (which will increase the buyer’s stock basis above the amount she paid to the departing shareholder), the offset may be of little value if it differs in timing or character from the allocation of income.\footnote{191}

B. Complete Redemption

As with C corporations, nonliquidating redemptions of S corporation stock are also taxable to the shareholder either as distributions or as sales or exchanges.\footnote{192} Complete redemptions are generally taxable as exchanges under Section 302, unless continuing ownership due to application of the attribution rules leads to distribution treatment.\footnote{193} However, a Subchapter S shareholder is much less likely to care about the outcome of the Section 302 analysis because distribution treatment in the Subchapter S context is very similar to sale or exchange treatment. In general, an S corporation distribution results in taxable gain, likely to be taxed at the favorable capital gains rate, only to the extent the distribution exceeds the shareholder’s basis in his or her stock.\footnote{194}

As with a sale of stock to a third party or remaining

making a \$754 election to adjust partnership asset basis in such circumstances. Note that recognition of a stock loss prior to business recognition of a corresponding loss may similarly lead to double deduction of the same loss (albeit by different owners).

191. This double tax may be avoided by having the corporation recognize its gain before the sale. If timed for the year of the departure transaction, it will not change the amount of income recognized by the departing shareholder, and will increase the amount of income for the remaining shareholders in that year.

192. See supra Part IVA (discussing sale or exchange consequences upon disposition of S corporation stock).

193. The Section 302(b) tests determine which set of rules will apply to a given redemption. See I.R.C. §§ 1368(a) (limiting its distribution rules to those distributions that would be taxable under I.R.C. §§ 301(c), were it to apply); 302(d) (stating that distributions not taxed as sales or exchanges under § 302(a) are to be taxed under § 301); 1371(a) (stating that Subchapter C rules, which include § 302, apply except to the extent inconsistent with Subchapter S rules).

194. However, if the S corporation has E&P left over from years when it was a C corporation, distribution, rather than sale or exchange, treatment could mean that some part or all of the redemption proceeds will be treated as an ordinary income dividend. See I.R.C. §§ 301, 302. Distributions to S corporation shareholders are not treated as ordinary income dividends unless the corporation: (1) was at one time a C corporation; (2) retains undistributed E&P from C corporation years; and (3) distributes all its S-year profits, or makes an election to treat the distribution as coming from C-year E&P. I.R.C. § 1368(c), (e)(3).
shareholder, Subchapter S income and loss for the year must be taken into account determining the tax consequences of the redemption, and the parties may want to consider making a closing of the books election to prevent misallocation of income between the departing and remaining shareholders. Whether the distribution proceeds are in cash or property, the corporation must reduce its accumulated adjustments account (AAA), if any, and E&P. If the redemption is taxable as an exchange, each account is reduced by the ratable share attributable to the redeemed shares. If the redemption is taxable as a Section 1368 distribution, each account is reduced by the amount of the distribution deemed to come from that account.

The possibility that the S corporation might distribute property to the departing shareholder raises a number of issues not present in a sale disposition. As with a C corporation, Subchapter S corporations must recognize any gain, but may not recognize any loss, triggered by a distribution of property to a shareholder in redemption of stock. The gain is allocated pro rata among the shareholders. As with any income allocation, however, such gain recognition should not increase the net income or loss of the departing shareholder for the year of the redemption but may affect the character of the income or loss.

Besides the possible character problem, there are a number

135. The S corporation's income and loss includes any gain triggered by transferring appreciated property to the departing shareholder in the redemption. I.R.C. § 302(d).
136. See supra Part IV.A. In the redemption context, the risk to the departing shareholder from failing to close the books relates to the character, rather than the amount, of income for the year. An over-allocation of ordinary income from corporate operations will increase stock basis by a corresponding amount, which will reduce the capital gain or increase the capital loss on the redemption. Id.
137. I.R.C. §§ 1368(e)(1)(B), 312(n)(7). For E&P, the reduction is limited by the amount actually distributed. I.R.C. § 312(n)(7).
138. I.R.C. §§ 312(a), 1368(e)(1)(A).
139. I.R.C. § 311. Such gain is generally allocated to the shareholders and does not create a corporate tax liability. I.R.C. §§ 1368(a), 1366. However, in an S corporation that was formerly a C corporation, gain that was built-in to the C corporation's assets at the time of the conversion can give rise to a corporate-level tax if recognized (e.g., upon distribution to a shareholder) within the ten-year period following the conversion. I.R.C. § 1374. It is the taxpayer's burden to prove any gain during the 10-year period is not subject to the § 1374 corporate tax. I.R.C. § 1374(d)(3).
140. See supra Part IV.A. (discussing the interaction of income allocations and stock basis).
of other problems that might be created by the distribution of property in complete redemption of the departing shareholder. First, to the extent distributing appreciated property accelerates income to other shareholders that would otherwise be deferred for a significant period of time, it may reduce the present value of the redeeming shareholder’s interest.\footnote{141} Moreover, the flowthrough gain can not be deferred under the provisions that might be applicable to the stock gain, such as the installment method. In addition, a former C corporation distributing appreciated property in redemption risks imposition of a corporate-level tax under Section 1374 unless it can establish that the gain was not built-in at the time of its conversion to an S corporation.\footnote{142} Finally, an S corporation using depreciated property to make a redemption will not be allowed to deduct the loss, which will be lost forever.\footnote{143}

Despite these disadvantages, there may be reasons why a departing shareholder would prefer a distribution of property over a distribution of cash. First, triggering unrealized income will mitigate any double tax problem created when stock gain is recognized before corresponding asset gain.\footnote{144} Thus, if the corporation would recognize the corporate level gain in the near future anyway, it may be worthwhile to accelerate the recognition by a short time to prevent remaining owners from being taxed on the portion of gain allocable to the departing shareholder.

For instance, suppose S Corporation owns appreciated real

\footnote{141. In other words, the shareholder's interest being the amount of redemption proceeds to which the remaining owners are willing to agree. Although the purchase price of stock sold to a third party or remaining owners should be discounted to take into account eventual corporate-level taxation of the business's appreciated assets, the present value of such tax will be lower, and the purchase price effect diminished, to the extent the tax can be deferred.}

\footnote{142. I.R.C. § 1374(a), (c)(2), (d)(1).}

\footnote{143. Again, this problem may be solved without resorting to a sale structure for the disposition by having the corporation sell the depreciated property and distribute the cash in redemption. \emph{But see} I.R.C. § 267 (disallowing losses from sales to related persons).}

\footnote{144. \emph{See supra} note 130. However, to the extent the potential double gain is reflected in both the departing shareholder's stock and in the distributed property, the allocation of income will be offset by a loss on the stock redemption, which will eliminate the second level of gain if of the same character. An example of a situation in which potential double gain is reflected in that way would be where the departing shareholder contributed appreciated property to the corporation in a tax-free exchange and took a basis in her stock equal to her pre-contribution basis in the contributed property under I.R.C. §§ 358 and 351.}
estate with a value of $500,000 and a tax basis of $400,000. Its other assets are worth $500,000 and have a tax basis of $500,000. Departing shareholder D owns fifty percent of the outstanding S Corporation stock. D’s stock is worth $500,000 and has a tax basis of $400,000. Remaining shareholder R holds stock worth $500,000 with a basis of $500,000. If S Corporation pays cash, issues a note or uses depreciated property to buy out D’s stock, the transaction will trigger no gain or loss at the corporate level, and D will realize taxable gain of $100,000 on the sale or exchange of stock ($500,000 redemption proceeds minus $400,000 basis). If and when S Corporation later sells the real estate, it will realize a gain of $100,000, which will flow through to R. R’s S Corporation stock basis will therefore be increased to $600,000, creating a built-in loss that may eventually be deducted. In the end, D and R will have been taxed on $200,000 of gain that may eventually be offset by R’s $100,000 built-in loss on her S Corporation stock.

If instead S Corporation distributes the appreciated real estate to D in complete redemption of his stock, S Corporation will recognize $100,000 of gain on that distribution. That gain will be allocated and taxed $50,000 to D and $50,000 to R. Such allocation will increase D and R’s stock basis to $450,000 and $550,000, respectively. Therefore, D’s gain on receipt of $500,000 in redemption proceeds will be $50,000 (rather than $100,000), and R’s built-in stock loss will be $50,000 (rather than $100,000). In the end, D and R will have been taxed on $150,000 of gain ($100,000 to D and $50,000 to R), which may eventually be offset by R’s $50,000 built-in loss on her S Corporation stock. By using the appreciated real estate to fund D’s redemption, the parties ensure that a portion of the taxable gain from that investment is allocated to D, thereby reducing (but not eliminating) the gain allocated to R. Of course, the trade-off is that the gain from the real estate will be taxed sooner rather than later. This acceleration may not be worthwhile if S Corporation could defer the real estate gain long enough to offset the cost of the “double tax.”

A second reason why the departing shareholder may prefer a property distribution, rather than cash, would be if the redemption will be taxed as a distribution rather than as an exchange, and there is a danger that a distribution of cash will be deemed to come from E&P left over from years as a C
corporation.\textsuperscript{145} Gain triggered by such a distribution will increase the corporation’s AAA, making it less likely that the redemption distribution will be deemed to be an ordinary income dividend coming from E&P.\textsuperscript{146} Of course, the remaining shareholders may object to this strategy as they will also be taxed on their portions of the gain triggered by the distribution and will see immediate benefit only to the extent that they receive distributions of other income that are sheltered by the basis increase accompanying the allocation of distribution gain.\textsuperscript{147}

For instance, suppose again that S Corporation has appreciated real estate worth $500,000 with a basis of $400,000 and other assets with fair market value and basis of $500,000. Departing shareholder D has S Corporation stock worth $500,000 and a basis of $400,000, while remaining shareholder R has S Corporation stock with a fair market value and basis of $500,000. In addition, suppose that S Corporation has E&P of $500,000 accumulated from years in which it was taxed as a C corporation and no money in its AAA. Finally, suppose that D’s redemption will be taxed as a distribution rather than as an exchange because R’s stock ownership is attributable to D and waiver of family attribution is unavailable.

If S Corporation pays cash, issues a note or uses depreciated property to buy out D’s stock, the transaction will trigger no gain or loss at the corporate level and there will be no adjustment to S’s AAA. All $500,000 of the distribution will be deemed to come from E&P and must be reported as ordinary income on D’s return for the year of redemption. D’s unused stock basis will be added to R’s stock basis, creating a $400,000 built-in loss. In the end, D will have been taxed on $500,000 at the higher ordinary income rates, which may eventually be “offset” by R’s

\textsuperscript{145} One reason a redemption could be taxed like a distribution would be where the departing shareholder retains a constructive ownership interest sufficient to preclude exchange treatment under the Section 302(b) tests.

\textsuperscript{146} See I.R.C. §§ 1368(e)(1)(A) (adjusting AAA in the same manner as stock basis is adjusted under I.R.C. § 1367), 1367(b)(1) (increasing stock basis for items of income allocated to shareholders), 1368(c)(1) (treating all distributions in S corporations with E&P as coming first from AAA and then from E&P).

\textsuperscript{147} See I.R.C. §§ 1366(a)(1), 1367(a)(1). Of course, the remaining shareholders should also take into account the benefit they receive if the departing shareholder accepts ordinary income distributions amounting to more than her “share” of the corporation’s E&P.
$400,000 built-in stock loss.

If instead S Corporation distributes the appreciated real estate to D in complete redemption of his stock, S Corporation will recognize $100,000 of gain on that distribution. That gain will be allocated and taxed $50,000 to D and $50,000 to R. Such allocation will increase D's and R's stock basis to $450,000 and $550,000, respectively. S's gain recognition will also increase its AAA to $100,000. The distribution of real estate to D will therefore be treated as a tax-free return of capital to the extent AAA does not exceed his stock basis, or $100,000, and an ordinary income dividend to the extent E&P does not exceed the remainder of the distribution, or $400,000. D's unused stock basis will be added to R's stock basis, leaving a total $400,000 built-in loss ($50,000 from the basis increase attributable to the real estate gain and $350,000 attributable to D's unused stock basis). In the end, D will have been taxed on $450,000 (rather than $500,000), with only $400,000 of that amount taxable at the higher ordinary income rates. R will pick up a $50,000 capital gain. The total taxable gain to D and R of $500,000 will be "offset" by the $400,000 built-in stock loss that R may eventually realize and deduct.

By using the appreciated real estate to fund D's redemption, the parties improve D's tax outcome by substituting capital gain ordinary income (to the extent of D's allocable share of the real estate gain, or $50,000) and reducing the total gain taxable to D (to the extent of AAA attributable to R's allocable share of the real estate gain, or $50,000). Of course, the trade-off is that R will be taxed sooner rather than later on her share of the gain from the real estate. This acceleration may not be worthwhile if S Corporation could defer the real estate gain long enough to offset the cost to D of incurring a higher tax cost.

C. Comparison of Structuring Alternatives

In general, there are a number of important similarities in the tax treatment of sales and redemptions of S corporation stock. Because each is generally treated as a taxable exchange, the shareholder should have the same amount and character of gain or loss regardless of which form of disposition is chosen. Since distributions and exchanges are treated similarly in the Subchapter S context, redemptions are not as risky, and continuing ownership by attribution does not present the same
risk for the redemption option as it does in the Subchapter C context.\textsuperscript{148} Moreover, each structure offers opportunities to avoid or defer shareholder gain in limited circumstances.

The biggest differences are between redemption for property, and other dispositions, whether sales or redemptions for cash. Whether a redemption for property leaves the parties better or worse off will depend on the particular circumstances.

Finally, the effect of a redemption on the corporation’s AAA and E&P, if any, may influence the choice of sale or redemption. Because the corporation does not reduce its AAA when a shareholder sells her stock to an outsider or the owners, more of the post-sale, rather than post-redemption, distributions will be favorably treated as coming out of AAA rather than E&P. On the other hand, since E&P is reduced by the ratable share attributable to redeemed shares (assuming the redemption is treated as an exchange and not a distribution), a redemption helps reduce the total amount of ordinary dividends that will eventually be repaid. However, since it also causes a ratable reduction in the AAA, a redemption may hasten dividend payments to the remaining shareholders.\textsuperscript{149}

For instance, suppose S Corporation has $200,000 of AAA and $500,000 of E&P. If departing shareholder D sells her fifty percent stock interest to a third party or remaining shareholder, those amounts will not change. Therefore, the remaining shareholders will be left with a potential $500,000 in ordinary income dividends hanging over their heads. At the same time, they may make $200,000 in nontaxable distributions before exhausting AAA and reaching the E&P layer. On the other hand, if S Corporation instead redeems D’s fifty percent stock for $500,000 in consideration, both AAA and E&P will be reduced by fifty percent, leaving $100,000 in AAA and $250,000 in E&P. The remaining shareholders will therefore be left with only $250,000 in potential ordinary income dividends, but they have also lost $100,000 of AAA cushion standing in the way of a dividend distribution.

Perhaps because the differences between sale and redep-

\textsuperscript{148} Therefore, it may be worthwhile to have the S corporation redeem stock without a waiver of family attribution in situations where the family attribution waiver requirements would pose a problem (e.g., if the departing shareholder will retain some interest in the corporation other than as a creditor).

\textsuperscript{149} See supra Part IV.B.
tion treatment are not great in the S corporation context, there does not appear to be the general risk of recharacterization by the IRS that hangs over C corporation owners. However, S shareholders are well advised to avoid mandatory cross-purchase agreements for the same reasons discussed in Part III.B.3 above with respect to C corporation shareholders. If the corporation ends up redeeming the departing shareholder’s stock, and the remaining shareholders are thereby relieved of a primary and unconditional obligation to purchase under the cross-purchase agreement, the remaining shareholders will have constructive distributions. Even if tax-free because the shareholders have sufficient basis, the distribution will cause a reduction in basis that will both hasten and increase\textsuperscript{150} future taxable distributions.

For instance, suppose that S Corporation has assets worth one million dollars. Departing shareholder D has S Corporation stock worth $500,000 and a basis of $400,000, while remaining shareholder R has S Corporation stock with a fair market value and basis of $500,000. Suppose further that S Corporation distributes $500,000 to D in a complete redemption qualifying for exchange (rather than distribution) treatment. If that distribution does not relieve R of a primary and unconditional obligation to purchase D’s stock, D will be taxed on her $100,000 stock gain, and R will incur no tax liability as a result of the redemption. With $500,000 of stock basis, R will be able to withdraw the entire remaining $500,000 in S Corporation value without triggering any gain with respect to her stock. However, if instead the redemption relieves R of a primary and unconditional obligation to purchase D’s stock, R will be deemed to receive a $500,000 distribution from S Corporation and D will be deemed to sell her stock to R, recognizing $100,000 in taxable gain. D will be no worse off, but R will. Although the entire deemed distribution will be treated as a tax-free return of capital to R, that treatment will trigger a corresponding basis reduction ($500,000 stock basis minus $500,000 distribution). With a zero dollar (rather than $500,000) stock basis, R will realize gain with respect to her stock on the withdrawal of the

\textsuperscript{150}This effect on the shareholder’s basis would occur because there would otherwise be no basis reduction to the remaining shareholders from redemption of the departing shareholder.
remaining $500,000 in S Corporation value.

V. DEPARTING OWNER IS A PARTNER (OR LLC OR LLP MEMBER)

A. Sale To a Third Party or Remaining Owner

In contrast to the corporation rules, the tax treatment of a sale of a partnership interest generally differs very significantly from that of a complete redemption of a partnership interest.\(^{151}\) Both sales and redemptions of stock, as well as sales of partnership interests, are treated as taxable exchanges—realization events on which tax must be paid in the absence of any affirmative nonrecognition provision. By contrast, the withdrawal of a partner is generally considered a nonevent for tax purposes. The withdrawing partner is not receiving consideration in exchange for his ownership interest but is rather simply removing from the partnership the share of partnership assets he has owned all along.\(^ {152}\) Therefore, withdrawals (also called redemptions or terminations or liquidations) are generally tax-free,\(^ {153}\) subject to significant exceptions, while sales are taxable exchanges similar to the sale of stock. Sale consequences are discussed in this section, while withdrawal consequences are discussed in the next section.

Gain or loss on the sale of a partnership interest is generally calculated in the same manner as in the stock context—if amount realized exceeds adjusted basis, the excess is taxable gain, but if the adjusted basis exceeds amount realized, the

\[^{151}\] For further background material see Edward E. Gonzalez, Basis and Other Considerations in Transfers of Partnership Interests and Contributions to Partnerships, 368 PLI/TAX 409 (1995); Michael G. Frankel & J. D. Dell, Planning For The Termination of An Interest In A Partnership—Withdrawals, Distributions, and Other Exit Strategies, CA04 ALI-ABA 343 (1995); see also William S. McKee et al., Federal Taxation of Partnerships and Partners (2d ed. 1990 & Supp. 1996) (discussing partnership tax issues indepth).

\[^{152}\] In Crawford v. Commissioner, 39 B.T.A. 521 (1939), the court explained the general rule that a distribution of property in liquidation of a partnership interest is not a taxable event. “The partnership fund was at all times the property of the [partners] and neither the dissolution of the partnership nor the distribution of the fund affected such ownership in any way.” Id. at 524. As the liquidated partner received merely his “aliquot part” of the partnership assets, “there was no disposition of partnership interest.” Id. at 525.

\[^{153}\] I.R.C. § 731(a), (b).
excess is a loss.\textsuperscript{154} However, in the partnership context, the partnership income/loss allocations\textsuperscript{155} and distributions of cash for the year of the sale must be taken into account, and outside basis\textsuperscript{156} adjusted, in determining the gain or loss on the sale. As in the Subchapter S context, basis adjustments for allocations of income and distributions from the partnership to the departing partner will affect the gain or loss realized on the sale. In addition, there are a number of other differences in the tax treatment of a sale of a partnership interest.

First, the amount realized on the sale includes the selling partner’s share of partnership liabilities from which she is relieved as a result of the sale.\textsuperscript{157} Moreover, although gain or loss on the sale of a partnership interest is generally capital in character, and therefore taxed at the favorable capital gains rate, the portion of the selling price attributable to the selling partner’s share of unrealized receivables or substantially appreciated inventory gives rise to ordinary gain or loss.\textsuperscript{158}

Second, as in the Subchapter S context, there is the possibility of a double tax of any gain reflected in both inside

\begin{footnotesize}
155. For purposes of allocating partnership tax items, I.R.C. § 706(c)(2) provides that the partnership’s taxable year closes as to a partner who sells his or her entire interest unless the partners elect to prorate the income between the periods before and after the sale (using a daily pro rata method or any other reasonable proration method). Treas. Reg. § 1.706-1(c)(2)(ii). As in the Subchapter S context, the trade-off between an interim closing of the books and a proration method is accuracy versus simplicity, respectively. Since it will frequently be difficult to tell at the time of the sale which party—seller or buyer—will benefit from prorating income between the pre- and post-sale periods, the parties may want to consider some sort of purchase price adjustment linked to eventual determination of the tax allocations for the year of sale.
156. “Outside basis” refers to the partner’s basis in her partnership interest, while “inside basis” refers to the partnership’s basis in its assets.
157. I.R.C. § 752(d); Treas. Reg. § 1.752-1(h). Relief from liabilities is included in amount realized as an offset against the partner’s previous outside basis increase for her share of the partnership’s liabilities. I.R.C. §§ 752(a), 722. This combination, of (1) basis for debt-financed investment plus (2) inclusion of relief from the debt for purposes of calculating gain on the investment, is a corollary to the rules for determining the basis and amount realized in the context of dispositions of property encumbered by debt. Treas. Reg. §§ 1.1001-2(a)(1), (3); see Tufts v. Commissioner, 461 U.S. 300 (1983); Crane v. Commissioner, 331 U.S. 1 (1947). Since stock basis is not increased by corporate liabilities (because shareholders are shielded from liability for corporate debt), shareholders are not better off than partners in determining their amount realized from the disposition of stock.
158. I.R.C. § 751. The definition of “unrealized receivables” is very broad in this context. See I.R.C. § 751(c). The definition of “substantially appreciated inventory” appears in I.R.C. § 751(d)(2).
\end{footnotesize}
and outside basis.\textsuperscript{159} Unlike the S corporation, a partnership may make an election to adjust its inside basis to reflect gain recognized by a departing partner as a result of the sale of his interest.\textsuperscript{160} The benefit of such basis step-up will go entirely to the buyer, who will not be taxed on the partnership’s eventual recognition of its corresponding gain.\textsuperscript{161}

There are some opportunities to avoid or defer gain from the sale of a partnership interest; three examples are: (1) stepped up basis at death;\textsuperscript{162} (2) nonrecognition on transfer to a spouse or former spouse;\textsuperscript{163} and (3) limited deferral of gain under the installment method.\textsuperscript{164} However, the installment method is not available to the extent of departing partner’s share of substantially appreciated inventory, depreciation recapture, unrealized receivables and other ordinary income items or to that the extent the departing partner is relieved of partnership liabilities.\textsuperscript{165} As with stock there is a specific exclusion denying like-kind exchange treatment on exchanges of partnership interests.\textsuperscript{166}

Although the same rules generally apply whether the sale is to a third party or to remaining partners, and Congress intended the partners to have a great deal of flexibility in selecting the form of their transaction for tax purposes,\textsuperscript{167} it is possible that a sale to remaining partners could be recharacterized as a redemption of the departing partner’s interest by the partnership if not properly documented (or if the buyers use partner-

\begin{itemize}
\item \textsuperscript{159} See supra note 130; example accompanying note 144. This result will occur if the partner is taxed on the gain prior to recognition at the partnership level.
\item \textsuperscript{160} I.R.C. § 743(b)(1).
\item \textsuperscript{161} I.R.C. § 743(b). Because a § 754 election may also cause inside basis to be stepped down to eliminate double losses, I.R.C. § 743(b)(2), care must be taken in determining whether making such an election will do more good than harm from the perspective of all the partners.
\item \textsuperscript{162} I.R.C. § 1014(a)(1); Treas. Reg. § 1.742-1.
\item \textsuperscript{163} If the departing partner sells her interest to her spouse incident to divorce, any gain or loss will be deferred and the spouse will take a carryover basis in the interest. I.R.C. § 1041. The buying spouse may be able to treat a cash payment made for the interest as deductible alimony. I.R.C. §§ 71, 215. See supra Part III.A.2.b.
\item \textsuperscript{164} I.R.C. § 453.
\item \textsuperscript{166} I.R.C. § 1081(a)(2)(D).
\item \textsuperscript{167} See, e.g., Foxman v. Commissioner, 41 T.C. 535, 549-51 (1964).
\end{itemize}
ship property as consideration for the purchase). In that case, the recharacterized transaction may be taxed under the sometimes different redemption rules discussed in the next section.

A sale results in termination if the withdrawing partner owns more than fifty percent of the total interest in the partnership. A termination prior to the effective date of new proposed regulations under Section 708(b)(1)(B) will be treated as if the partnership’s property were distributed to the partners pro rata and recontributed to the partnership. This deemed distribution/contribution could have numerous, mostly undesirable, consequences. If the partnership is deemed to distribute money, including any money deemed distributed due to relief from liabilities, the deemed distribution may result in taxable gain to the partners. The deemed distribution/contribution may also change the partnership’s basis in its assets. In addition, termination will discontinue any election to adjust basis in partnership property under Section 754.

However, under proposed regulations that will become

168. STEPHEN UTZ, FEDERAL INCOME TAXATION OF PARTNERS AND PARTNERSHIPS 203 (3d ed. 1995). See infra Part V.B-C (discussing Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971)).
169. See, e.g., Foxman, 41 T.C. at 547-553.
172. Treas. Reg. § 1.708-1(b)(1)(iv). However, there should be gain from any deemed decrease in the partners’ share of partnership liabilities to the extent such decrease is not matched by an increase caused by the deemed recontribution of the partnership property to a “new” partnership. Treas. Reg. § 1.752-1(f). See generally John Birkeland & Philip Postlewaite, Constructive Termination of A Partnership—A Fresh Look, 39 TAX LAW. 701 (1986).
175. The deemed distribution will substitute the partners’ basis in their partnership interests for the partnership’s basis in its assets, and the partners’ new asset basis will then become the partnership’s basis upon the deemed contribution. I.R.C. §§ 752(b), 722; see 61 Fed. Reg. 21,985, 21,986.
176. Treas. Reg. § 1.708-1(b)(1)(iv); see also Birkeland & Postlewaite, supra note 172, at 721.
effective when finalized, termination is treated as a deemed contribution by the partnership to a new partnership in exchange for an interest in the new partnership and distribution of the interest in the new partnership to the partners pro rata. Under this "down and up" approach to deemed termination, some, but not all, of the undesirable consequences of termination will be avoided. The partners will not risk gain recognition because there will be no deemed distribution of money, and the partnership's asset basis will not change. However, the tax year of the partnership will still close, any partnership elections will still be invalidated and various other consequences of termination will continue to occur.

B. Complete Withdrawal

1. Overview

The tax treatment of a partner who completely liquidates her or his interest in a continuing partnership will be determined by Section 736. Payments in complete redemption of a partnership interest fall into two categories: (1) those that are in exchange for partnership property (Section 736(b) payments) and (2) those that are not (Section 736(a) payments). The latter category is further divided into payments considered a distributive share of partnership income and guaranteed payments. This scheme reflects an assumption that

179. 61 Fed. Reg. 21,985-86.
180. Id.
181. Id. at 21,985-88.
182. In general, the tax treatment of partnership distributions depends on whether they are liquidating distributions (whether of a single partner withdrawing from a continuing partnership or of all the partners) or nonliquidating distributions. UTZ, supra note 168, at 207-08. "[L]iquidation of a partner's interest [is] the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership." I.R.C. § 761(d). With regard to liquidating distributions, there are many similarities between the treatment of a partner who is withdrawing from a continuing partnership and a liquidation of the entire partnership. However, I.R.C. § 736 provides some special rules for the tax treatment of the departing partner. Note that § 736 applies to any withdrawing partner, including one being forced out.
183. I.R.C. § 736(b).
184. I.R.C. § 736(a).
payments to a departing partner will generally serve three purposes: (1) compensation for the partner’s share of the value of partnership property (Section 736(b) payments), (2) compensation for the partner’s share of uncollected amounts owed for work performed or goods supplied by the partnership (Section 736(a)(1) payments) and (3) mutual insurance (Section 736(a)(2) payments).  

2. Allocating among Payment Categories

Subject to certain exceptions discussed below, section 736(b) payments may be more attractive to the departing partner because they can result in capital gains or nonrecognition treatment, while Section 736(a) payments give rise to ordinary income. On the other hand, Section 736(a) payments may be more attractive to the remaining partners because they are excludable or deductible to the remaining partners, while Section 736(b) payments are not. Because the parties have adverse interests in allocating redemption payments between the two categories, the Service will generally respect the allocation of the parties. However, allocation to payments in exchange for partnership property is, at least in theory, constrained by the value of the property. In addition, if the departing partner is a general partner in a service partnership, special rules govern payments for specific types of partnership property, as addressed immediately below.

a. Service Partnerships

Payments for the departing general service partner’s interest in unrealized receivables are considered in exchange for partnership property only to the extent of the partnership’s basis, if any, in the receivables. Any such payments in excess of basis are considered Section 736(a) distributive share or

187. Cf. Tolmach v. Commissioner, 62 T.C.M. 1102 (1991) (refusing to look past the allocation of payments set forth in the partnership agreement on the ground "Congress has allowed the withdrawing and continuing partners to allocate the resulting tax benefits and burdens [associated with goodwill payments] as they see fit.").
188. I.R.C. § 736(b)(2)(B), (b)(3); Treas. Reg. § 1.736-1(b)(2).
guaranteed payments.\textsuperscript{189} (Payments for the partner’s share of inventory are considered payments for property.\textsuperscript{190})

In general, payments to a departing general service partner for goodwill are treated as payments in exchange for partnership property only to the extent of the partnership’s basis in the goodwill.\textsuperscript{191} Payments for goodwill in excess of basis are Section 736 payments for distributive share or guaranteed payments.\textsuperscript{192} However, payments for goodwill made by provision of the partnership agreement are considered payments in exchange for partnership property.\textsuperscript{193} This rule provides considerable leeway for the partners to negotiate the treatment of goodwill.\textsuperscript{194}

3. Payments in Exchange for Partnership Property

a. Partner Consequences

Payments in exchange for the departing partner’s interest in partnership property are treated as distributions by the partnership and are therefore governed by the general distribution rules of Sections 731 through 735.\textsuperscript{195} Thus, such payments are generally tax-free to the departing partner except to the extent any money distributed exceeds the partner’s outside basis.\textsuperscript{196} “Money” includes “marketable securities” in excess of the distributee partner’s share of such securities held by the partnership\textsuperscript{197} and the departing partner’s share of partnership

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{189} \textit{Id.}
\item\textsuperscript{190} Treas. Reg. § 1.736-1(b)(4).
\item\textsuperscript{191} I.R.C. § 736(b)(2)(B), (3); Treas. Reg. § 1.736-1(b)(3).
\item\textsuperscript{192} \textit{Id.}
\item\textsuperscript{193} I.R.C. § 736(b)(2)(B), (3).
\item\textsuperscript{194} \textit{See} McKee et al., \textit{supra} note 151, at 22-7, S22-2-7.
\item\textsuperscript{195} \textit{See} I.R.C. §§ 736(b)(1), 731(a). Note that if the departing partner is a general partner in a service partnership, any payment for the value of unrealized receivables in excess of the partnership’s basis is not considered in exchange for partnership property but will be taxed as a payment of the partner’s distributive share or a guaranteed payment, in either case ordinary income.
\item\textsuperscript{196} I.R.C. § 731(a)(1).
\item\textsuperscript{197} I.R.C. § 731(c)(1)(A), (c)(3)(B); Prop. Reg. § 1.731-2(a). There are three exceptions to the treatment of a distribution of excess marketable securities as a distribution of money: (1) distribution of securities contributed by the distributee partner, (2) distribution of securities that were not marketable securities when acquired by the partnership, and (3) distribution of securities by an “investment partnership” to an “eligible partner.” I.R.C. § 731(c)(3). The complex rules treating marketable securities as money in certain circumstances were added to I.R.C. § 731 by § 741(a) of the
\end{enumerate}
\end{footnotesize}
liabilities from which she is relieved as a result of the withdrawal. The character of any taxable gain will generally be capital.

Gain on a partnership withdrawal may be deferred to the extent payments in exchange for the partner’s interest are deferred. In that case, the departing partner will not be taxed until he has recovered his entire basis. Moreover, a withdrawing partner receiving deferred payments who remains economically at risk with respect to partnership liabilities may not trigger a deemed distribution of money from relief from such liabilities until the withdrawal process is complete.

In contrast to a shareholder redemption, a departing partner may generally receive partnership property without incurring tax liability. Furthermore, tax-free treatment in the partnership liquidation context, unlike the sale context, extends to the departing partner’s share of unrealized receivables and substantially appreciated inventory. However, the

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Uruguay Round Agreements Act of 1994, Public Law 103-465, and have been interpreted by the IRS in proposed regulations issued on January 8, 1996. See Prop. Reg. § 1.751-2, 61 F.R. 28-33. Details of these complex rules are beyond the scope of this article.

198. I.R.C. § 752(b). Note that a partner may avoid relief from liability upon withdrawal from a partnership by arranging to remain personally liable for the debt even after the withdrawal. See Weiss v. Commissioner, 956 F.2d 242 (11th Cir. 1992) (a partner’s personal guarantee of partnership debt prevented relief from the liability that would otherwise result in a gain on the termination of his partnership interest).

199. See I.R.C. § 731(a). However, the departing shareholder may have ordinary income if she receives less than her share of unrealized receivables or substantially appreciated inventory. See supra note 195.

200. I.R.C. § 736(b).

201. See I.R.C. § 731(a)(1) (no gain on distributions of cash until they exceed the distributee partner’s basis in his partnership interest).


203. I.R.C. § 731(a)(1); cf. I.R.C. §§ 301(c), 302(a) (imposing taxable treatment on shareholders receiving distributions of property).

204. I.R.C. § 751(b)(1). However, any gain or loss on a subsequent disposition of "unrealized receivables" received in the withdrawal retains its character as an ordinary gain or loss regardless of whether the property is a capital asset in the hands of the departing partner. I.R.C. § 735(a)(1). Similarly, any subsequent gain or loss on inventory received in the distribution retains its ordinary character for five years after the distribution. I.R.C. § 735(a)(2). Section 735 does not apply to any unrealized receivables or substantially appreciated inventory in excess of the departing partner’s share of such items. Such excess § 751 property is deemed by § 751(b) to have been acquired from the partnership in a taxable exchange that is not subject to the distribution rules of §§ 731-36. Treas. Reg. § 1.751-1(b)(1)(i); see infra note 205.
departing partner and the partnership may recognize gain or loss if there is a disproportionate distribution with respect to these items.\(^{205}\) In general, the partner takes a basis in any property distributed equal to her basis in the partnership (outside basis) minus any money received.\(^{206}\) The substituted basis rule generally preserves unrecognized gains and losses for future taxation.\(^{207}\)

As in the partnership interest sale context, the basis adjustment rules leave room for the doubling of some tax burdens and benefits in a partnership with no Section 754 election in effect.\(^{208}\) Where there is a Section 754 election in the liquidation context, however, there may an adjustment when the departing partner's basis in property received, which is taken from that partner's outside basis, differs from the partnership's inside basis in such property.\(^{209}\) This adjustment may also be necessary when the departing partner recognizes a gain or loss.\(^{210}\)

An otherwise tax-free distribution of property under Section 731 may be treated as part of a taxable exchange of property between partners under the anti-abuse provisions of Sections

\(^{205}\) See I.R.C. § 751(b)(1). If the departing partner receives less than her share of § 751 property, she must recognize ordinary income as if she had exchanged the portion she did not receive for other partnership assets in a taxable transaction. I.R.C. § 751(b)(1)(B). On the other hand, if the departing partner receives more than her share of § 751 property, she is treated as having exchanged her share of other partnership property for the excess § 751 property in a taxable transaction. In this case, the partnership will recognize ordinary income from the "sale" of the excess § 751 property, and the partner will recognize gain or loss, as the case may be, realized from the deemed exchange of her share of other assets. See Treas. Reg. § 1.751-1(g) (examples 2-4); see also William D. Andrews, Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions, 47 Tax L. Rev. 3 (1992) (discussing the effect of distributions of "hot assets" under § 751).

\(^{206}\) I.R.C. § 732(a). Since § 751 property in excess of the departing partner's share is deemed acquired from the partnership in a taxable exchange under § 751(b)(1)(A), the departing partner should take a cost basis in such property under § 1012 rather than a transferred basis under § 732(b). See Treas. Reg. § 1.751-1(b)(1)(i). Similarly, to the extent the departing partner is deemed under § 751(b)(1)(B) to have exchanged all or a portion of his share in § 751 property for other property, such other property should take a cost basis. Id.

\(^{207}\) Nonrecognition has its price. To the extent transferred basis is lower than the cost basis that the departing partner would have in property received in a taxable transaction, the departing partner will also have lower depreciation deduction with respect to such property. See I.R.C. §§ 167, 168.

\(^{208}\) See generally supra note 130; example accompanying note 144.

\(^{209}\) See I.R.C. §§ 732(a)(2), (b), 734(b)(1)(B), (b)(2)(B).

\(^{210}\) See I.R.C. §§ 731(a), 734(b)(1)(A), (b)(2)(A).
704(c)(1)(B) (contributing partner recognizes pre-contribution gain if the property is distributed to another partner within five years of the contribution), 707(a)(2)(B) (disguised sales taxed as taxable exchanges)\textsuperscript{211} or Section 737 (contributing partner recognizes pre-contribution gain if the partnership distributes other property to the contributing partner within five years of the contribution).

As with the sale of a partnership interest, opportunities for avoidance and deferral are limited. The installment method, while generally available, may not be used to defer gain on the departing partner's share of: (1) substantially appreciated inventory; (2) depreciation recapture; (3) unrealized receivables and other ordinary income items; or (4) gain from relief from partnership liabilities.\textsuperscript{212} Since these are the items most likely to give rise to taxable gain in the partnership liquidation context, it is unlikely that the departing partner will be able to defer significant portions of her gain. However, the departing partner may consider accepting a series of liquidating payments over time to approximate the deferral results of the installment method.\textsuperscript{213}

Losses are allowed only on distributions in liquidation of a partner's interest involving money, unrealized receivables, and inventory.\textsuperscript{214} Any loss is measured by the difference between the partner's outside basis and the sum of any money received plus his share of the inside basis in the unrealized receivables and inventory.\textsuperscript{215} Thus, a loss may be recognized even though the value of the property received exceeds the departing partner's outside basis. Any loss is generally capital in character.\textsuperscript{216}

\textsuperscript{211} Where there is a transfer by a partner of property to a partnership and a transfer of money or other consideration by the partnership to the same partner, if (1) there would have been no transfer of money or other consideration without the transfer of property and (2) where the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations. Treas. Reg. § 1.707-3(b)(1).
\textsuperscript{212} I.R.C. § 453.
\textsuperscript{213} See McKee et al., supra note 151, at 15-11 to BB 3.4(b)-12.
\textsuperscript{214} I.R.C. § 731(a)(2). These items need not be disproportionately distributed and the inventory need not be "substantially appreciated" for this loss rule to apply. See I.R.C. § 731(a)(2)(B).
\textsuperscript{215} I.R.C. § 731(a)(2).
\textsuperscript{216} Id.; I.R.C. § 741.
b. Partnership Consequences

Partnerships do not recognize gain or loss on the distribution to a partner of cash or any other property in the redemption context or otherwise, unless Section 751 (relating to unrealized receivables and substantially appreciated inventory) applies.217 Neither does the partnership receive any exclusions or deductions for Section 736(b) payments.

4. Payments Not in Exchange for Partnership Property

Payments not in exchange for partnership property are treated in one of two ways. First, payments determined by reference to partnership income will be treated as the departing partner’s distributive share of partnership income and will be included in that partner’s income, with character depending on the character of the partnership income.218 Payments of the departing partner’s distributive share are excludable in allocating partnership income to the other partners.219 Second, payments not determined by reference to partnership income will be treated as guaranteed payments that will be ordinary income to the redeeming partner and deductible to the partnership.220

5. Termination of the Partnership

 Withdrawal of one member of a two-person partnership will cause the partnership to terminate for tax purposes.221

C. Comparison of Structuring Alternatives

In contrast to the corporation rules, the tax treatment of a sale of a partnership interest can differ dramatically from that of a complete redemption of a partnership interest.222 In gener-

217. I.R.C. §§ 731(b), 751(b)(1); see also supra notes 208-10 (discussing the of effect of § 751(b)(1)).
218. I.R.C. § 736(a)(1). The character of the partnership income is determined under § 702.
221. I.R.C. § 708(b)(1)(A); see supra text accompanying notes 170-81.
222. See MCKEE ET AL., supra note 151, at 15-12 to -13 (discussing the differences between withdrawal and sale treatment for a departing partner); Sheldon I. Banoff, Sales and Redemptions of Partnership Interests Under the Passive Loss Regulations, 68 J. TAX’N 352 (1988) (discussing passive loss issues arising in the context of sales and redemptions of partnership interests, which are beyond the scope of this article).
al, a departing partner should prefer redemption over sale structure if benefit can be obtained from allocation to deductible or excludable Section 736(a) payments, and to the extent the redemption payment can be made in the form of a tax-free distribution of appreciated property.\textsuperscript{223}

Another benefit of withdrawal over a sale is that ordinary income associated with unrealized receivables and substantially appreciated inventory can be deferred to the extent the departing partner receives his pro rata share of such items in a withdrawal transaction. By contrast, a departing partner who sells her interest will be taxed on any gain in her interest, with gain attributable to her share of unrealized receivables and substantially appreciated inventory being taxed at ordinary income rates. In addition, payments to a withdrawing partner for her share of unrealized receivables will be taxable to that partner and not to the partnership,\textsuperscript{224} thereby ensuring that the remaining partners will not be taxed on the departing partner's share of such receivables. By contrast, although a selling partner is taxed at the ordinary income rates to the extent her sale of a partnership interest is considered a sale of as if she sold her share of the partnership's unrealized receivables,\textsuperscript{225} that tax payment will not shelter the remaining partners from taxation on the receivables unless the partnership has in effect a Section 754 election.\textsuperscript{226}

To the extent gain \textit{would} otherwise be taxed upon the departing partner's withdrawal, there are significantly more favorable gain deferral opportunities in the withdrawal context. These include the ability to recover all basis tax-free before incurring taxable gain on any deferred taxable payments and the possibility of deferring the deemed distribution of money caused by relief from partnership liabilities until the withdrawal process is complete.

Finally, only sale can result in termination if the departing

\textsuperscript{223} However, note that disproportionate distributions of relatively liquid appreciated assets—marketable securities—may be taxed to the extent they exceed the partner’s outside basis. Therefore, deferral may come at the cost of foregoing liquidity.

\textsuperscript{224} I.R.C. § 736(a).

\textsuperscript{225} I.R.C. § 751 (a).

\textsuperscript{226} See MCKEE \textit{et al.}, \textit{supra} note 151, at 15-12 to -13; \textit{supra} note 130 and accompanying text.
partner owns more than fifty percent of the partnership.227 However, redemption of less than a fifty percent interest can result in termination of a two-person partnership.228 This difference will not be as significant once the new proposed termination regulations go into effect.229

Against these considerable advantages to structuring a departure as a withdrawal, there are a couple of situations in which sale treatment may be preferable. First, transfers to spouses are subject to complete deferral.230 Moreover, losses are generally allowed to the partner only in a sale of the partnership interest.231 However, a loss may be allowed on a redemption of a partner's interest involving no property other than money, unrealized receivables and inventory.232

Because of the significant differences in tax treatment depending on the form of the partnership departure transaction, the IRS may attempt to recharacterize a transaction structured as a withdrawal if it accomplishes in substance the economic results associated with a sale.233 For instance, in Crenshaw, the partners constructed an elaborate series of exchanges to take advantage of the tax-free property distribution rules and avoid taxable sale treatment. The transaction involved the following four steps:

(1) the partnership distributed to Frances Wood Wilson, the departing partner, an undivided two-ninths interest in the Pine Forest Apartments (the Apartments) in liquidation of her two-ninths interest in the

227. See supra text accompanying notes 170-81.
228. See supra Part V.B.5.
229. See supra text accompanying notes 170-81.
230. See supra note 163.
231. See supra Part V.A text accompanying n. 154).
232. See supra Part V.B.3.a (text accompanying notes 214-216).
233. See Crenshaw v. United States, 450 F.2d 472 (5th Cir. 1971); Foxman v. Commissioner, 41 T.C. 535 (1964). Recharacterization is particularly likely in a cash distribution to a withdrawing partner that is accompanied by a disproportionate increase in the interest of some remaining partner. See Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793 (1988) (admission of new general partner taxed as sale of portion of interest of existing general partner); Daniel Coven v. Commissioner, 66 T.C. 295 (1976) (withdrawal treated as sale where, among other things, interests of minority partners are unaffected by the withdrawal). See generally Mckee ET AL., supra note 151, at 15-20. A sale of a partnership interest may be recharacterized as a sale of partnership assets by the partnership. See Mckee ET AL., supra note 159, at 15-27 to -32. Moreover, a sale to remaining partners may be recharacterized as a distribution to the departing partner. See supra text accompanying notes 167-69.
partnership; 234
(2) acting on her own behalf and as executrix of her husband’s estate, Mrs. Wilson exchanged her interest in the Apartments for the estate’s interest in an income-producing shopping center; 235
(3) the estate sold the undivided interest in the Apartments to a new corporation (the Blair Investment Company) formed by the remaining partners, the Blairs, for $200,000; 236 and
(4) the Blair Investment Company contributed the undivided interest in the Apartments to the partnership in exchange for a partnership interest equal to Mrs. Wilson’s interest prior to her withdrawal. 237

As a result of these four steps, Frances Wood relinquished her two-ninths partnership interest and ended up with a shopping center, her husband’s estate exchanged the shopping center for cash, and the Blair’s corporation parted with cash and acquired a two-ninths partnership interest. 238 The Fifth Circuit referred to substance over form and step transaction notions in holding that the four steps amounted to a taxable sale by Frances Wood of her partnership interest to the Blairs (through their alter ego, the Blair Investment Company) followed by a cash purchase of the shopping center.

As Crenshaw illustrates, it can be difficult for a partner to take advantage of the tax-free withdrawal of partnership property if the partnership property cannot be easily divided, is not liquid or income-producing, or is otherwise not in a form that the withdrawing partner can use without selling or exchanging it for something else. 239 One solution to consider is having the partnership distribute property that can be exchanged in a like-kind exchange for property more desirable to the departing partner. 240 In structuring such a transaction, it is critical to avoid the fatal fourth step of the Crenshaw transaction-the

234. Crenshaw, 450 F.2d at 474.
235. Id.
236. Id.
237. Id.
238. See McKee et al., supra note 151, at 15-21.
239. Recall that certain distributions of marketable securities are treated as a distribution of cash, taxable to the extent the value of the securities exceeds the partner’s outside basis. I.R.C. § 731(c).
240. See I.R.C. § 1031.
property distributed to the departing partner must not be recontributed to the partnership in exchange for a partnership interest. 241 However, if a like-kind exchange transaction will not work, 242 the departing partner may have to engage in a taxable transaction to convert the partnership property into property that will serve his or her needs. 243

VI. CHOICE-OF-ENTITY COMPARISON

Focusing on the tax consequences of exiting a business, the business vehicle of choice seems clear. Only the partnership rules offer broadly available tax-free transfers of appreciated assets from business to owner. Even as between flowthrough entities, the timing advantage offered by partnership-level tax deferral on liquidations of appreciated assets appears tremendous. The C corporation may appear to offer the next best opportunity in the form of a fourteen percent rate on any disposition of qualifying small business stock. 244 However, that "favorable" rate may be imposed in addition to a tax on the corporation's income. 245 In the abstract, then, it is safe to conclude that the partnership vehicle offers the biggest opportu-

241. See David P. Kelley, II, The Tax-Deferred Limited Partner Buyout: The Substance is the Form, 3 J. PARTNERSHIP TAX'N 117, 126-30, 192-93 (1986); MCKEE ET AL., supra note 151, at 15-21, 15-24. Note that the distributed property may be leased back to the partnership without converting the distribution to a sale. See Harris v. Commissioner, 61 T.C. 770 (1974) (holding that a distribution of an interest in property eventually leased back to the partnership and then sold (subject to the lease), to a related trust would not be recharacterized as a sale of the departing partner's partnership interest because the trust did not obtain a partnership interest and held only an interest in former partnership real estate). See also MCKEE ET AL., supra note 151, at 15-23 to -24.

242. This option may not work if there is no asset the partnership can do without, or if the partnership's assets are not "like-kind" with respect to property the departing partner wishes to obtain.

243. The departing partner may consider having the partnership purchase the property she desires and then distributing it. If the partnership does not have cash available to do that, it may borrow against its other assets or otherwise finance the purchase. If the partnership sells appreciated property to obtain funds, taxable gain will flow through to the partners, including the departing partner, in contravention of the goal of obtaining tax-free treatment. I.R.C. § 702. However, the IRS would have a strong argument that a purchase on behalf of a departing partner should be treated as a taxable distribution of cash followed by a purchase by the departing partner. See Kelley, supra note 241, at 194-97.

244. See supra Part III.2.a.

nity and the C corporation the biggest risk. Nonetheless, for each type of entity, the particular choice of how and when to structure the owner’s departure can have dramatically different consequences than those just outlined. This section examines how specific exit circumstances might influence the choice-of-entity decision.

In making the exit cost comparisons, there are two potential pitfalls to avoid: (1) limiting the discussion to worst-case scenarios, and (2) limiting the discussion to a comparison of identical transactions. Before beginning the entity comparison, it is important to explain these two pitfalls.

First, when comparing the tax features of the three major entity choices, it is all too easy to frame the analysis in something like the following terms: how will this business enterprise be taxed if its income is fully taxed, and taxed sooner rather than later? For instance, choice-of-entity analysis highlights double taxation of C corporation equity,\textsuperscript{246} even though part or all of one or both of the C corporation taxes may be deferred or avoided altogether.\textsuperscript{247} While such worst-case comparisons must be taken into account in any sensible business plan, focusing on


\textsuperscript{247} For instance, the corporate tax on income paid to a shareholder may be avoided by paying the shareholder deductible compensation in reasonable amount. I.R.C. § 162(a)(1); see Elliotts, Inc. v. Commissioner, 716 F.2d 1241, 1243, 1245 (9th Cir. 1983). The shareholder tax on appreciated stock may be avoided by holding the stock until death, at which time the basis in the stock will be “stepped up” to fair market value, eliminating any untaxed gain. I.R.C. § 1014(a)(1). Although compensation does not, strictly speaking, represent a return on the equity investment of the owner, so that it is not the kind of income that is subject to double taxation, the distinction between compensation for labor and return on equity may be of little significance to an owner who actively participates in the management of the business (hence the term “sweat equity”). The difficulty of distinguishing between a return on equity and compensation for services is exacerbated by the fact that compensation based on profitability of the business may nonetheless be treated as compensation rather than a return on equity. \textit{Elliotts, Inc.}, \textit{supra}, at 1248 (holding that incentive payment plan paying the shareholder-employee a bonus equal to 50% of the corporation’s annual profit was not unreasonable per se). See \textsc{Professor Schmedemann’s Article} (highlighting the difficulty of distinguishing between owner qua owner and owner qua employee). See Deborah Schmedemann, \textit{Fired Employees and/or Frozen-out Shareholders (An Essay)}, 22 WM. MITCHELL L. REV. 1495 (1996) (accompanying article in this issue).
the worst-case may mask opportunities available to the business owner that plans ahead.

In fact, the Internal Revenue Code offers both businesses and owners means of deferring or avoiding taxation of income.\textsuperscript{248} Businesses enjoy limited opportunities to avoid business recognition altogether,\textsuperscript{249} defer business income indefinitely\textsuperscript{250} or defer business income for the short-term.\textsuperscript{251} In the context of departure transactions, a business may generate resources to fund a redemption or withdrawal without triggering otherwise deferred taxation of its income by borrowing against its appreciated assets or, in the case of a partnership, distributing appreciated property to the departing partner. A sale of the departing owner's interest to a third party may also serve as a means of avoiding business-level taxation of otherwise deferred income. At the owner-level, there are also opportunities for shorter-term deferral,\textsuperscript{252} indefinite deferral\textsuperscript{253} and complete

\begin{itemize}
\item \textsuperscript{248} To understand the analysis in this part, keep in mind that recognition of business income may take place at one or both of two levels. The business may recognize income with respect to its operations and assets, and the owner may recognize income with respect to her interest in the business. This is as true in a flowthrough entity as it is in a C corporation. In a flowthrough entity, most income will not be taxed at both levels because business-level recognition will increase the owner's stock or partnership interest basis to prevent taxation of the same income at the owner level. However, the timing of recognition at one or the other level may affect the opportunities for deferral, as well as the overall rate of tax imposed on the pass-through business investment. For this purpose, recognition is used very broadly to refer to the time at which income or loss is taken into account for tax purposes regardless of the form of income or loss. Hence, "recognition" is not limited to gain or loss from a disposition of property but may also refer to ordinary receipts from the sales of inventory or services.

\item \textsuperscript{249} For instance, the business may make deductible payments to owners in the form of compensation, interest or rent. See, e.g., \textit{Elliot, Inc.}, 716 F.2d at 1243, 1245 (corporation may deduct reasonable compensation paid to shareholder-employee); \textit{Fin Hay Realty Co. v. United States}, 398 F.2d 694, 695 (3d Cir. 1968) (corporation may deduct interest paid to shareholder-lender); \textit{Langer v. Commissioner}, 59 T.C.M. (CCH) 740 (1990) (corporation may deduct rent paid to shareholder-lessee).

\item \textsuperscript{250} For instance, the business may invest in property that will appreciate in value. Any such appreciation will not be taxed until the business disposes of the property. See Fellows & Yuhas, \textit{supra} note 165.

\item \textsuperscript{251} For instance, the business may use the installment method to defer gain on the sale of property not held for sale to customers in the ordinary course of its business. A business may also defer recognition by using deductions that are not economically warranted, such as accelerated depreciation or current deduction of long-term expenses, to shelter current taxable income at the expense of increased future taxable income.

\item \textsuperscript{252} For instance, the departing owner may sell or redeem her interest in an installment sale qualifying for deferred taxation of gain under the installment method. I.R.C. § 453.
\end{itemize}
avoidance.\textsuperscript{254}

Second, to thoroughly and fairly compare the tax costs and opportunities among the three forms of business entity, it is not adequate to compare how the same transaction will be treated under the three sets of rules. To some extent, in structuring a departure transaction, both consideration and transaction form may be flexible. Thus, the departing owner may have a range of departure options from which to choose, especially if she is able to plan ahead. Therefore, it makes sense to consider whether the three sets of rules offer similar tax opportunities, albeit in different transaction forms.

To extend the analysis beyond the worst-case and identical transactions limitations, the following discussion divides potential departure transactions into four categories that represent points ranging along a continuum from zero percent tax on the present value (as of the time of making the choice-of-entity decision) of the pre-tax income from the business enterprise up to more than fifty percent. These categories are addressed in Sections A through D. Each of these sections provides examples of the types of departure structures that fall within the category and analyzes the effect of the deferral opportunity represented by the category on taxation of the business investment.

Section A addresses transactions in which both the owner and business have deferred, and will continue to defer, recognition of the income of the business enterprise (maximum deferral transactions). Section B addresses transactions in which the business has already recognized, or will as a result of the transaction recognize, taxable income from the business enterprise but the owner has not yet recognized taxable income from the business enterprise (owner deferral transactions). Section C addresses transactions in which the owner has already recognized, or will as a result of the transaction recognize, taxable income from the business enterprise but the business will not yet have recognized taxable income from the business enterprise (business deferral transactions). Section D addresses

\textsuperscript{253} For instance, the departing owner may defer gain by structuring the departure as an ESOP rollover sale of C corporation stock, a sale to a spouse or former spouse, an exchange of stock in a tax-free corporate reorganization, or a withdrawal from a partnership in exchange for appreciated property.

\textsuperscript{254} For instance, the shareholder may hold the stock until death and take advantage of stepped up basis. \textit{See supra} Part III.A.2.f.
transactions in which the business and owner have already recognized, or will as a result of the transaction recognize, taxable income from the business enterprise (minimum deferral transactions). To complete the comparison, Section E will address the treatment of losses of the departing owner, and Section F will compare the flexibility of the alternative tax vehicles in light of uncertain disposition circumstances.

A. Maximum Deferral Transactions

The tax-free withdrawal of appreciated assets from a partnership by a liquidating partner provides an example of a maximum deferral transaction. By investing in appreciating assets, the partnership generates tax-deferred income, which can be withdrawn by a departing partner without triggering taxation. Does the partnership vehicle stand alone in offering this kind of opportunity to the closely held business?

All three vehicles offer similar limited opportunities to generate tax-deferred income by investing in appreciating property, holding tax-exempt securities, selling assets on the installment method and the like. However, because a distribution of appreciated property from either kind of corporation triggers taxation of the appreciation, neither corporate vehicle provides the identical opportunity afforded by the partnership distribution rules—tax-free use of appreciated business assets to fund the departure. Nonetheless, the tax rules applicable to both types of corporate vehicle do provide alternative opportunities to achieve similar tax results for the business and departing owner.

For example, both S and C corporation owners can transfer their interests to other owners or outsiders while deferring or avoiding tax by making use of the corporate reorganization rules, the installment method, tax-deferred transfers among spouses, transfers to an ESOP in a transaction qualifying for tax-free rollover of the gain (in the case of a C corporation) or stepped

255. To simplify discussion, opportunities for avoiding taxation altogether will be included in the discussion of the deferral options and not separately analyzed.

256. This article does not address opportunities for businesses to defer or avoid income generated outside the departure transaction context. These are just a few examples of business deferral techniques to illustrate that such deferral is more than hypothetical. The focus here is whether any such deferral can be continued past the departure transaction or will be taxed as a result of the departure.
up basis at death. To the extent tax on the original investment has been deferred through investment in appreciating assets, the owner will have deferred both business-level and owner-level recognition of income. Moreover, all these deferral options offer the possibility of long-term, or even indefinite, deferral or avoidance of tax on the business enterprise.

While all three vehicles offer opportunities to exit the particular business incurring owner-level recognition or triggering business-level recognition, each opportunity poses different trade-offs. The partnership rules allow assets to be separated from the business in a tax-free manner. Unlike the corporate shareholder, there is no need to find an outside buyer, let alone a buyer willing to acquire the entire business. Moreover, the ability to separate assets from the business may make possible a subsequent like-kind exchange, allowing the departing partner to obtain more useful property without triggering tax on the deferred gain. On the other hand, the departing partner will not be allowed to receive property that is particularly liquid without being taxed.257

By contrast, corporate deferral opportunities require a departing shareholder to either hold her stock until death or sell to a remaining shareholder or third party. The Code does not permit tax-free transfers of corporate assets to the departing shareholder. Moreover, the departing shareholder must accept the limitations typically imposed on the consideration that can be received in a tax-free transaction in order to qualify for deferral. Thus, for instance, the success of a tax-free reorganization as an exit strategy will depend on, among other things, whether there is a corporation that is willing to acquire the entire business in a tax-free reorganization, and whether consideration in the form of acquiring corporation stock serves the purposes of the departing owner.258 Yet, the corporate

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257. Recall that withdrawals of more than the departing partner's share of "marketable securities" from a partnership are taxable to the extent the disproportionate distribution exceeds the partner's outside basis. See supra text accompanying notes 197. In a partnership with substantial unrealized appreciation, the partner's outside basis is likely to be lower and therefore the liquidating distribution is more likely to be taxable.

258. For instance, trading closely held stock for closely held stock in a tax-free reorganization will not serve the departing owner's need for liquid consideration if the new shares are not tradable. Note that any subsequent disposition of acquiring corporation stock by the departing shareholder may destroy the continuity of
deferral and avoidance rules may allow the shareholder to make a significant change in her investment while obtaining property that is more liquid than the type of property permitted to be withdrawn from a partnership tax-free. In the tax-free reorganization context, for instance, the consideration may be publicly traded stock that can be sold as funds are needed or it may be preferred stock paying regular dividend income.

B. Owner Deferral Transactions

Opportunities for deferral of business-level recognition are limited. Most businesses cannot avoid current taxation of their income, and businesses that can take advantage of deferral opportunities are unlikely to be able to defer all of their income. Moreover, the departure transaction itself may trigger business-level recognition, as in a distribution of appreciated property in redemption of stock. The objective in this section is to compare the effect of and opportunities for deferring tax on the departing owner even if the business tax cannot be deferred. The main lesson of this section is that deferral of owner recognition from investment in a business that is taxed currently on its business may (1) reduce the overall rate of tax on the C corporation business below that applicable to the flowthrough business and (2) provide no additional benefit to the flowthrough business owner beyond that afforded by the flowthrough taxation rules.

The business will recognize income prior to, or as a result of, the departure transaction in the following situations: (1) corporate redemptions and partnership withdrawals for cash which has not been borrowed by the business,259 (2) corporate redemptions involving a distribution of property,260 (3) partnership withdrawals involving the kind of property giving rise to

shareholder interest required for the acquisition to qualify for tax-free treatment if the subsequent sale is integrated with the acquisition under the step transaction doctrine. See Ginsburg & Levin, supra note 48, at § 106.9.

259. The presence of cash without debt generally signals that the business enterprise has already been taxed to the extent of the cash. This holds true because, other than by borrowing, it is difficult to convert assets or services into cash without being taxed.

260. Whether the property is worth more, less, or the same as the corporation's basis in the property, the corporation will either be taxed as a result of the distribution (in the case of property with basis less than fair market value) or have been taxed on income equal to at least as much as the value of the property prior to the distribution (in the case of property with basis greater than or equal to fair market value).
a taxable distribution to the departing partner\textsuperscript{261} and (4) sales to a remaining owner or third party in a business that has already recognized its income. In these situations, all three types of entities offer the possibility of deferring owner recognition through an installment disposition,\textsuperscript{262} a transfer between spouses\textsuperscript{263} or a transfer after death. In addition, C corporation shareholders selling to third parties may take advantage of other deferral options, such as the tax-free reorganization rules and the ESOP rollover rules.

With regard to the effect of shareholder tax avoidance on the C corporation rate, if the shareholder tax can be avoided, only the corporate level will be imposed. For individuals in the 36\% and 39.6\% brackets, the corporate rate (likely no more than 34\%) is lower, which may make it more attractive to use a C corporation if double tax can be avoided or deferred indefinitely.\textsuperscript{264} The gap can appear even wider when the lower corporate brackets and the hidden marginal rate provisions are taken into account.\textsuperscript{265}

\textsuperscript{261} A withdrawing partner will be taxed to the extent the distribution exceeds her basis in her partnership interest and involves a disproportionate share of hot assets or marketable securities, relief from partnership liabilities, property purchased on behalf of the partner in a transaction recharacterized as a constructive distribution of cash, or property triggering one of the \textit{deemed sale} rules. \textit{See supra} Part V.B.3.a.

\textsuperscript{262} Recall that use of the installment method will not be available to defer owner gain on a sale of a partnership interest to the extent the partner is deemed to be selling an interest in ordinary income assets.

\textsuperscript{263} Recall that a withdrawal or redemption for the benefit of the remaining spouse may be deemed to accomplish a tax-free transfer between spouses. \textit{Arnes v. Commissioner}, 981 F.2d 456 (9th Cir. 1992), \textit{aff'd} 91-1 USTC \textsection 50,207 (W.D. Wash. 1991).

\textsuperscript{264} Indefinite shareholder gain deferral may be accomplished through stepped up basis at death, nonrecognition upon divorce, sale to an ESOP qualifying for rollover treatment or disposition in a tax-free reorganization.

\textsuperscript{265} The corporate tax rate on taxable income up to $50,000 is 15\%, while the corporate rate on taxable income between $50,000 and $75,000 is 25\%. I.R.C. \textsection 11(b)(1)(A), (B). These rates are lower than the 28\% rate applicable to joint filer taxable income between $40,000 and $75,000 and single filer taxable income between $24,000 and $50,000. \textit{See Rev. Proc. 95-53, 1995-52 I.R.B. 22} (setting forth inflation adjustment individual income tax rate brackets for taxable years ending in 1996). The effective top marginal ordinary income rates imposed by I.R.S. \textsection 1(a)-(d). Provisions such as the proposal exemption phase-out of I.R.C. \textsection 151(d)(3) and the limitation on itemized deductions imposed by I.R.C. \textsection 68 operate effectively to increase the affected taxpayer's top marginal rate because the reduction in tax benefits increase with each additional dollar earned by the taxpayer. \textit{See Robert B. Thompson, The Taming of Limited Liability Companies, 66 U. Col. L. Rev. 921, 930 (1995); Deborah A. Geier, Cognitive Theory and the Selling of the Flat Tax, 96 TNT 71-46, Apr. 10, 1996 (available in DIALOG, TNT File). However, for the business that generates primarily capital gains,
Turning to the flowthrough business context, if the business has been taxed currently or will be taxed as a result of the transaction, owner deferral techniques, such as use of the installment method, will not improve the owner's tax position. The flowthrough owner is taxed on the business income as it is recognized by the business. Corresponding basis increase will prevent taxation on the sale or redemption of hr interest. Thus, there will be no gain to defer if the business has already fully recognized its income.

The net result is that both C corporation and flowthrough investments will be taxed as a result of recognition at the business level, while owner-level recognition deferral. The extent to which the gap between the C corporation “double tax” and flowthrough “single tax” rates will be bridged as a result of the owner-level deferral will depend on how long the departing C corporation shareholder will be able to prolong the deferral. Total avoidance of the tax, or deferral for so long a period that the present value cost of the eventual tax is negligible, will leave the C corporation shareholder in a better position than the flowthrough owner whenever the C corporation rate is lower than the individual rate that would otherwise apply. However, if the C corporation owner’s deferral is relatively short, then the present value of the C corporation owner’s tax is likely to push the overall rate investment in the C corporation above the overall rate that would have applied had the same business been operated in a flowthrough entity.

Again, in this context, the particulars of the transaction make the difference in the inter-entity comparison. While it is safe to generalize that flowthrough investments are taxed at a lower rate, it is not safe to conclude that all C corporation investments must therefore be taxed at a higher rate. In fact, many small businesses may be able to take advantage of owner deferral or avoidance opportunities to reduce the effective rate of tax on the C corporation investment to a level competitive with the flowthrough rate.

the individual capital gains rate (28%), which is applicable to income from flowthrough businesses, will be more advantageous than the top corporate rate (probably 34% for in the small business context).
C. Business Deferral Transactions

Even if the business is able to defer taxation on its income, the departing owner may find it difficult to avoid or defer taxation on the sale or redemption of her business interest. This will be the case in the following situations involving an interest in a business that has deferred recognition of its income: (1) taxable sales to third parties and remaining owners for cash or property, (2) corporate redemptions and partnership withdrawals for cash that has been borrowed by the business, and (3) partnership withdrawals involving the kind of property giving rise to a taxable distribution to the departing partner. The objective of this section is to compare the effect of and opportunities for deferring the business tax if the owner tax cannot be deferred.

As with owner deferral, transactions in which business recognition can be deferred or avoided offer an opportunity to reduce the corporate tax rate. And, similar to owner deferrals, the owner departing from a flowthrough entity will be fully taxed on the business investment despite the continuing business-level deferral. Since the flowthrough owner’s basis will not have been increased by allocations of business income, the owner will have more gain or less loss as a result of the taxable sale or redemption than if the business had earlier been taxed on its income. The net result is that both C corporation and flowthrough investments will be taxed at the owner-level, and no other level, as of the time of the departure transaction.

Although the amount of income and timing of owner

266. A business distributing cash that has not been borrowed has likely been taxed to the extent of the cash. Transactions in which both the business and the owner have experienced recognition events are addressed in the minimum deferral transaction section below.

267. Such a withdrawal transaction would include disproportionate distributions of hot assets or marketable securities and distributions relieving the withdrawing partner’s partnership liabilities. See supra Part V.B.3.a.

268. Again, the extent of reduction will depend on how long the deferral can be maintained. Total avoidance (such as by paying the owner deductible compensation in reasonable amounts) or indefinite deferral, will reduce the effective rate of tax on the corporate investment to the same rate as applies to flowthrough entities (or lower if the 14% rate applies or the hot asset rule would lead to ordinary income treatment were business operated as a partnership, as discussed below). However, short-term deferral may mean leaving the effective corporate tax rate significantly higher than the rate on similar passthrough businesses.
recognition will generally be the same regardless of entity type, there may be a substantially different tax rate applied to the owner’s income depending on the type of entity and other factors. In general, the taxable sale or redemption of a business interest is treated as a disposition of a capital asset taxable at the twenty-eight percent capital gains rate for all owners. Thus, where ordinary business income has been deferred, departing owners may generally convert ordinary income into capital gain by selling or redeeming their interests. This analysis is subject to important exceptions. First, some C corporation shareholders may enjoy a fourteen percent rate due to the fifty percent exclusion of gain on the disposition of certain small business stock.

Focusing only on the flowthrough entities, there is an important advantage in this context that partnerships have over S corporations. To the extent a flowthrough owner is taxed on ownership interest value attributable to as yet untaxed income of the business, a double tax may be created. The departing owner will be taxed on any gain attributable to untaxed business income, and the new or remaining owners will be taxed again when the business finally recognizes its income. Although the second tax may be offset by the corresponding basis increase, the offset may not fully make up for the second tax if it differs in timing or character from the allocation of gain. This double tax can be avoided in the partnership context if there is in effect as of the time of the departure transaction a Section 754 election to step up the partnership basis in its assets to reflect the gain first taxed to the departing owner. However, there is no similar adjustment to corporation asset basis available in the Subchapter S context. When the eventual double tax is taken into account, the Subchapter S tax turns out to be higher than the partnership tax by the net present value of the difference between the cost of the second tax and any benefit created by the corresponding

269. Of course, such dispositions would be subject to the collapsible corporation rules. I.R.C. § 341.

270. Only the C corporation form offers an absolute exclusion from income in the form of the 50% exclusion for capital gains on the sale of stock held more than five years if acquired by original issue from a corporation with less than $50 million in value. See supra Part III.A.2.a.

271. For instance, the basis increase may create an eventual capital loss on the disposition of the new owner’s interest.
basis increase.\textsuperscript{272}

D. Minimum Deferral Transactions

If prior to or as a result of the transaction the income from the business enterprise is fully taxed, and owner-level recognition is triggered by the departure transaction, the C corporation will be the least desirable of the three tax vehicles while the flowthrough entities appear equally attractive. This will be the case in the following situations involving an interest in a business that has realized or will realize as a result of the transaction all of its income: (1) sales to third parties and remaining owners for cash or property, (2) corporate redemptions and partnership withdrawals for cash that has not been borrowed by the business, (3) corporate redemptions involving a distribution of appreciated property, and (4) partnership withdrawals involving the kind of property giving rise to a taxable distribution to the departing partner.\textsuperscript{273}

In these transactions, the business income will be taxed in its entirety either before or as a result of the departure. Although the C corporation’s shareholder tax in this context may be as low as fourteen percent, that low rate cannot make up for the overall burden of double taxation. Applied on top of the thirty-five percent top corporate rate, the “favorable” fourteen percent rate applied when the departing shareholder sells or redeems her stock is roughly fourteen percent more than would apply in the S corporation or partnership context.\textsuperscript{274}

\textsuperscript{272} See supra note 130; example accompanying note 144; text accompanying notes 159-61; text accompanying notes 208-10.

\textsuperscript{273} Such a withdrawal transaction would include disproportionate distributions of hot assets or marketable securities, distributions relieveing the withdrawing partner’s partnership liabilities, and distributions of property purchased on behalf of the partner in a transaction recharacterized as a constructive distribution of cash.

\textsuperscript{274} Application of the top marginal capital gains rate 28\% to 50\% of stock gain results in a 14\% rate. This shareholder tax applies in addition to (but not necessarily at the same time) as the corporate rate. This tax could be as high as 35\%, but is likely to be 34\%. A 34\% tax on $100 of C corporation earnings leaves $66 to pay to the departing shareholder in redemption of her stock. Even if the 14\% rate applied to the $66, for a tax of $9.24, the shareholder is left with only $56.76 after the two taxes are taken into account. Even if the corporate tax has been deferred all along (e.g., by paying deductible compensation to the shareholders and reinvesting the remainder in currently deductible expenses), the corporation will eventually have to pay tax on any earnings distributed to shareholders, even if only in liquidation. The present value of the eventual corporate-level tax should reduce the value of the stock relative to the value of an equivalent investment in an S corporation or partnership. Even stepped up
comparison, the flowthrough owner will have been taxed at a top capital gains rate of twenty-eight percent and a top marginal ordinary income rate of thirty-six percent.

E. Loss Transactions

As in the gain context, a loss may be recognized at the business level with respect to business property or at the owner level with respect to the interest in the business. As none of the three entities recognizes a loss on the distribution of depreciated property to a departing owner when the business itself is not liquidating,275 the comparison in this section will focus on recognition of losses with respect to the owner’s interest in the business.

The same nonrecognition treatment that makes partnership taxation relatively attractive when the partnership distributes appreciated property to a departing partner appears relatively unattractive when the partner’s interest in the partnership is worth less than her outside basis. Departing partners are allowed to recognize losses in their interests only when they receive from the partnership nothing other than cash, unrealized receivables and inventory.276 By contrast, both C corporation and S corporation owners may recognize stock losses on complete redemptions regardless of the nature of the redemption proceeds. In addition, shareholders and partners alike may recognize a loss on the sale of a business interest.

In general, such losses recognized with respect to an interest in any type of entity are capital in character, but Section 1244 may afford ordinary loss treatment to departing shareholders of both C corporations and S corporations. Such treatment is not available to departing partners, who must recognize a capital loss

275. C corporations and S corporations may recognize losses on distributions of depreciated property in complete liquidation of the corporation, subject to limitations on disproportionate distributions of loss property to certain related shareholders and deduction of losses stuffed into the corporation in anticipation of the liquidation. I.R.C. § 356(a), (d). Partnerships generally do not recognize losses on liquidating distributions of depreciated property. I.R.C. § 731(b).

276. However, since the departing partner’s unrecognized loss is preserved when her outside basis becomes her basis in any property received, she may trigger a loss by selling the property received.
on the sale of a partnership interest even to the extent the loss is attributable to hot assets. However, a withdrawing (versus selling) partner who receives ordinary income property with exchanged outside basis preserving the unrecognized loss in the partner’s interest may sell such property to trigger an ordinary loss.²⁷⁷

As in the gain context, C corporations and shareholders may, in some circumstances, take the same loss into account at both the business and owner levels. For instance, the corporation may sell loss property to a third party to finance the complete redemption of the departing shareholder, who may then recognize a loss upon exchange of her stock in the redemption. Even in the flowthrough context, there may be double losses. For instance, a loss reflected in both outside and inside partnership basis may be triggered first when the departing partner sells to a third party and second when the partnership later disposes of the loss property (unless the partnership has in effect at the time of the departing partner’s sale a Section 754 election stepping down the partnership’s inside basis to reflect the departing partner’s loss).

In sum, focusing on the departure transaction alone and its affect on losses unrecognized prior to the departure, corporation treatment appears most advantageous in the context of sales to a remaining owner or third party, to the extent the Section 1244 ordinary loss rules apply. Corporation treatment also appears most advantageous in the redemption context because shareholders are not limited in the consideration they may receive in order to claim a loss. As between C and S corporations, the C corporation might appear the most attractive because of the possibility of double losses in certain circumstances.

However, as in the gain context, a complete entity comparison must take into account losses recognized by the business prior to the departure transaction. In that context, the flowthrough vehicles clearly have the advantage because they allow losses to be passed through to owners, who may be able to use them to offset income from other sources. By contrast, C corporation losses are trapped in the C corporation and will not

²⁷⁷. The withdrawing partner will recognize an ordinary loss on any unrealized receivable whenever such loss is later recognized. Inventory losses retain their ordinary character for five years after the distribution in liquidation of the partner’s interest.
be available to the owner to offset income from other sources until the departure transaction. This timing difference may tip the scales in favor of the flowthrough entities. However, to the extent foreseeable losses will not be recognized until the departure transaction, C corporation treatment may be preferable.

F. Flexibility of Business Taxation

With the uncertainty faced by most business owners at the time the choice-of-entity decision must be made, it may be difficult to take the tax treatment of departure from the business into account.278 For many owners, flexibility of the vehicle to minimize tax costs in a variety of exit circumstances may be the most important consideration when choosing a vehicle through which to conduct the business. Nonetheless, flexibility is difficult to judge in the abstract.

Even in the partnership context, which appears to offer significant “flexibility” in the form of tax-free liquidating distributions of appreciated property, the benefits are fitted with shackles. Mrs. Crenshaw could not simply sell her partnership interest to her partners, the Blairs, for there was too much at stake if she forsook her “aliquot part” of the partnership’s assets in favor of “cashing in” her investment.279 At the other end of the flexibility spectrum, the C corporation owner is faced with a potential difference in treatment that is almost as dramatic—exchange treatment versus dividend treatment.280 Ironically, the least variable is the simple S corporation, which, left in the dust of large, complex, public C corporations and flexible limited liability vehicles, stands as a monument to tax simplification qua simplification.281 Even there though, planning can

278. Nonrecognition on transfers between spouses and stepped up basis at death provide deferral and forgiveness, respectively, for owners of all entities upon the occurrence of two of the more unpredictable events that might lead to departure from a business. Therefore, planning will likely focus on such events as voluntary or forced retirement and disability.

279. See supra text accompanying notes 239-38. Four exchanges were devised to take the place of one.

280. Mrs. Crenshaw invested in the wrong vehicle if satisfaction is relative. The exchange treatment she fought so hard to obtain looks pretty appealing when a dividend is the alternative.

make a big difference and implications of alternative tax consequences can be elusive. 282

A very important consideration in the C corporation context is the uncertainty of planning for future owners or for shifting congressional priorities. With regard to the first point, even if the original owners can plan their affairs to avoid double taxation, they will not be able to foresee whether future owners will be able to do so. Therefore, the original owners run the risk that the value of their interests to a prospective successor will be discounted by the prospect of double taxation. 283

A similar point can be made about the risks presented by changes in the tax law. Because of the difficulty of getting assets out of the corporate solution tax-free, it may be more difficult for C corporation owners to respond to tax law changes that make the C corporation vehicle relatively less desirable than it already is. 284 Under current law, the option remains to convert to S corporation status, if the corporation qualifies. The problem of “trapped assets” will be exacerbated if President Clinton succeeds in treating S corporation conversions as taxable liquidations and making it difficult to combine tax-free divisions and acquisitions, which together provide limited means of disposing of a part of a C corporation business. 285

G. Summary

All three vehicles offer opportunities to continue any business-level deferral through an owner deferral at the time of departure. However, the nature of the opportunity is different in the partnership context than it is in the corporation context, and predicting which opportunity will be needed at the time of

282. See supra Part IV.C. (discussing tax considerations in structuring a departure from an S corporation investment).

283. This risk is not alleviated by stepped up basis at death, which eliminates double taxation only on past gain. Income earned by the corporation after death will continue to be double taxed unless the heirs can plan around it.

284. A similar problem exists for S corporation owners because they too may not withdraw assets from the corporate solution without paying a tax. However, because a lower rate of tax is currently built in for S corporations, there is less risk of tax changes that will greatly increase the relative taxation of S corporation investments over investments in other tax vehicles. Planning to avoid or defer C corporation double taxation is much less reliable.

the departure may be difficult. In the partnership context, the issue will be whether the business has appreciated assets it can spare that will serve the purposes of the departing partner. In the corporation context, the issue will be whether the departing shareholder can locate a buyer that will allow for tax-free reorganization treatment or other owner deferral treatment. The nature of the consideration to the departing owner will also be a concern in the tax-free reorganization context.

Moreover, all three vehicles offer opportunities to defer one or the other of business- or owner-level recognition. However, because of the interaction of business-level taxation and owner-level basis, single-level deferral in a flowthrough entity will not be effective to continue any previous deferral past the time of the departure transaction. The good news is that such deferral is not as urgent in the flowthrough context as it is in the C corporation context, where a significantly higher overall rate of tax is at stake. The bad news is that total deferral of income in flowthroughs entities depends on effective deferral of both levels of recognition, just as in the double tax regime.

In any context in which full recognition at both levels is likely, C corporation tax treatment is significantly more expensive. This will be true also in owner or business deferral contexts in which the deferred gain will be taxed soon enough that the present value of the second tax will boost the C corporation rate over the individual rate that would otherwise be applicable were the business to operate in a passthrough vehicle. Since these constitute the vast majority of situations, C corporation ownership will often be the last choice of closely held business owners. The owner who can defer or avoid the business-level tax will be indifferent as between the C corporation and S corporation form, and should have a preference for the partnership form, with its Section 754 election. However, the owner who can plan to avoid or defer the owner-level tax (or both levels) will be significantly better off in a C corporation than in a flowthrough entity.

VII. CONCLUSION

The departing owner will be taxed differently depending on the disposition structure, type of business entity involved, nature of the consideration and, sometimes, the identity of the buyer. Predicting which vehicle will be the most favorable depends on
the interaction of a variety of factors, only some of which are likely to be foreseeable at the time the choice-of-entity decision must be made.

In the end, as with everything in the law, the choice of entity analysis is almost entirely contingent on the particular plans of the particular owners of a particular business. Even flexibility cannot be evaluated without reference to particular circumstances. The contingent nature of tax benefits and burdens obviously makes advance planning both critical and extremely difficult. However, to the extent a business owner can foresee the means by which she hopes eventually to make her exit from the business, she should take that plan into account in selecting the vehicle by which to operate her business.

Contrasting the tax-deferred partnership distribution rules with the single tax on a similar S corporation transaction or double tax on a similar C corporation transaction begs the question of which vehicle offers the most opportunity for tax avoidance and deferral by setting up an unduly narrow comparison. Almost all investments will be taxed when ultimately cashed out (unless held past death), including partnership investments. Tax-free liquidation only works to the extent partnership income has been deferred (through holding appreciating assets) and partnership assets are flexible enough to permit use of appreciated property (other than hot assets) in a liquidating distribution. Thus, it may make sense to think of the three different tax vehicles in a more fluid way—combining the timing of and marginal rate applicable to projected gains and losses into a single rate.