Closing the Circle: Taxing Business Transformations

Daniel M. Schneider
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* Professor of Law, Northern Illinois University College of Law. I would like to thank Allan J. Samansky, Paul E. Hoelschen, Jr., Beverly I. Moran, and William J. Rands for their comments on earlier drafts of this article.
I. INTRODUCTION

What type of entity is best for running a business? Lawyers who counsel business clients know that there is no one "right" entity. Operating as a proprietorship, as a partnership, or as a corporation all may make sense, each for the appropriate business reason. The fiduciary relationship between associates, for example, may suggest that a partnership is the best way for a particular client to engage in business, while the insulation of an entrepreneur from her business' liabilities may dictate use of a corporation.

Federal income taxation also affects choice of entity. For example, a "C" corporation is taxed separately from its shareholders.1 "Imposition" of tax on the corporation's income "twice"—once in its hands and again when it is distributed to its shareholders—is more onerous than a tax imposed solely on the owners of a business. But if the shareholders can afford to have the corporation accumulate its earnings or, alternatively, to have the corporation deduct payments it makes to them, then the tax is diminished to the point that doing business as a C corporation becomes attractive.2 Entrepreneurs may want to draw down all

2. See infra Section IIIA.
of the business' profits, or to allocate income of the business differently from its
deductions. In these cases, doing business as a partnership, or perhaps as an "S"
corporation, becomes more attractive.¹

Thus, how to do business compels an entrepreneur and her attorney to
consider both the tax and the non-tax business consequences that flow from the
choice. While basic patterns exist, each situation deserves particular consider-
ation. Each entrepreneur has her own needs, and so each entrepreneur's solution
must be shaped by her concerns.

In many ways, federal tax law affirms existing business practices,⁴ at least
where such practices do not lead to the perceived avoidance of tax.⁵ Recently,
for example, the federal income tax characterization of entities was simplified
by the Internal Revenue Service's publication of Notice 95-14 and accompanying
regulations promulgated under Internal Revenue Code Section 7701.⁶ With
these two pronouncements, the Service permitted unincorporated businesses to
elect the form in which they chose to be taxed. Before the Notice's issuance,
businesses were required to meet relatively formal requirements in order to be
taxed as doing business in a particular form.⁷ The Notice and regulations,
however, permitted unincorporated businesses to choose much more readily how
they will be taxed. A business need only comply with the Notice or regula-
tions—essentially check the appropriate box on its tax return—and not comply
with former, more formal, requirements—in order to be taxed in a particular
manner. Some of the origin of this change in choice of entity lay in the
increased popularity of limited liability companies.⁸

Another longer-standing example of tax law following business practices is
the fairly ubiquitous policy that mere changes in the form of doing business are
not taxed. For example, an entrepreneur who wants to convert her proprietorship
into a corporation should be able to do so without being taxed in the conver-
sion.⁹ These changes are not taxed because gain or loss—whatever appreciation
or depreciation is inherent in the business' assets since the business acquired

³. See I.R.C. §§ 701 (partners, not partnership, taxed), 704 (partners' distributive share of
items of partnership income, deductions, etc.), 1363 (shareholders, not S corporation taxed), 1366
(pass-through of corporation's items of income, deductions, etc., to shareholders) (1997).
⁴. For example, a corporation makes distributions to its shareholders under state law. See,
e.g., 805 Ill. Comp. Stats., 5/9.10 (West 1997). Corporate tax law has assumed a consistent position,
generally taxing shareholders only as dividends are distributed to them by C corporations. See I.R.C.
§ 301(c) (1997).
⁵. For example, a corporation's "unreasonable" retention of profits—one that minimizes the
overall federal income tax imposed on the corporation and its shareholders—is thwarts by the
accumulated earnings and the personal holding company taxes. See I.R.C. §§ 531-537 (accumulated
earnings tax), 541-547 (1997) (personal holding company tax). See also infra Section IIIA and Table
1 (discusses and illustrates benefits of C corporation's retaining of its profits).
⁶. I.R.S. Notice 95-14, 1995-1 C.B. 297; Treas. Reg. §§ 301.7701-1 to -3 (as amended in
1996).
⁷. See infra Section IV.B.2.
⁹. See infra Section IV.C.2.a.
them, or in the owner's equity in the business—"realized" in the transaction is not "recognized." And, in turn, this nonrecognition means that the gain or loss is not currently taxed and, probably, will not be taxed until the new entity sells the old business' properties or the owner sells her interest in the business. Thus, a proprietor may incorporate her business without recognizing gain or loss, despite the fact that the immediate sale of the same assets would be taxed, even if they would then be used to start an identical business. The same is true of transfers into partnerships.

Some dramatic shifts in doing business are taxed, the most notable of which is terminating the business. Because there may be no further chance to tax the business, termination becomes a taxable event. The business is transformed, and because the transformation encompasses the possible cessation of the business, taxation becomes imperative.

Are "mid-life" changes in a business more like the organization or the termination of the business; in other words, should they escape, or be subjected to, tax? They resemble organizing a business because mid-life changes tend to escape taxation. One striking exception to this statement is the change from doing business as a corporation to either doing business as a partnership or to doing business as a proprietorship. The transformation of a corporation into a partnership gains special significance because S corporations have been and should continue to be converted into limited liability companies ("LLCs"). For tax purposes, such a conversion leads from doing business as a corporation to doing business as a partnership. The relative inflexibility of an S corporation and the relative flexibility of an LLC make these conversions likely, such that avoiding tax on such conversions will become more important as time passes.

This article proposes that the Code be amended to permit the tax-free conversion of corporations into partnerships, more fully completing the circle not

10. See I.R.C. § 1001 (1997) (gain or loss realized usually is recognized, unless a nonrecognition provision applies).

11. See infra Section IV.C.2.a; I.R.C. §§ 1001(a), (c) (sale or other disposition leads to realization and recognition, usually, of gain or loss); 351 (transfer of property to controlled corporation does not lead to recognition of realized gain or loss); 721 (transfer of property to partnership does not lead to recognition of realized gain or loss) (1997).

12. This pattern can be discerned in I.R.C. §§ 331, which taxes shareholders, and 336 (1997), which taxes corporations that distribute property, when a corporation liquidates. Taxation of a partnership's termination is more complex, but the same point can still be made. If a partner's interest in a partnership is liquidated, the distribution made in liquidation is taxed under Section 736. If the partnership terminates, then the distribution is taxed under Sections 731-733, discussed infra Section III.D., still leads to taxation, either during the distribution itself or when the partner sells property she receives in the distribution. Should a proprietorship terminate, the proprietor will be taxed if and as she disposes of the assets associated with the proprietorship under Section 1001, supra note 11.

yet closed, of not taxing transformations in ongoing businesses. The current analogy of such transformations to a corporation's liquidation is fallacious, and subverts the policy otherwise advanced by the Code that business transformations not be taxed. Modest proposals have been made along these lines, but are not as broad as or as thorough as the one made in this article; those proposals also will be discussed. This article also examines consequences flowing from implementing such a proposal, and concludes that the proposed change could fit easily into tax principles already in place. This article does not examine the conversion of a corporation into a proprietorship. It seems likely, however, that similar considerations would prevail whether a corporation converts into an LLC/partnership or proprietorship, save only unique questions raised by the partnership form of doing business. The popularity of LLCs dictates review of corporate conversions into partnerships.

This article specifically proposes that nonrecognition be granted to the transaction in which a corporation converts into a partnership, most probably by defining that event as the corporation's transferring its assets to the partnership and terminating or merging into the partnership. Only in the limited circumstance that a C corporation converts into a partnership could an argument be made that the corporation's "built-in gain," which may be taxed now even after a C corporation converts into an S corporation, be taxed when the conversion instead is into a partnership.

Consequences would flow from rendering this conversion into a nonrecognition event. Contributions to the partnership would not be any more taxable than they are under current partnership tax law. Profits from the converted enterprise would already have been taxed. To the extent that they were not, however, some method comparable to taxing a C corporation's untaxed profits as it converts into an S corporation should be adopted. Debt that accompanies the old enterprise into the partnership would be treated as it is under partnership tax law, either as recourse or nonrecourse debt, and clearly as nonrecourse debt if the new enterprise is an LLC.

The road map of the remainder of this article is best approached in reverse order of the actual discussion. The article proposes how the Code should be amended to render the conversion of corporations into partnerships into a nontaxable event. Specifically, these conversions should become nonrecognition events. If the Code were so amended, its present structure would accommodate many of the tax consequences flowing from the change. This proposal can best be understood only within the context of how other business transformations are taxed, and so a summary of the taxation of these other business transformations precedes discussion of the proposal. To the author, granting nonrecognition to corporation-to-partnership conversions more fully closes the circle extended to other nonliquidating transformations. In other words, the structure of other pertinent segments of the Code dictates extending nonrecognition to this last midlife transformation. Taxation of transformations can best be understood by examining the different types of entities; thus, why a certain entity may be attractive for particular business and tax reasons is discussed first.
Thus, the remaining sections of this article discuss the different types of entities, how business transformations presently are taxed, and a proposal for not taxing the conversion of corporations into partnerships.

II. THE DIFFERENT TYPES OF ENTITIES AND REASONS FOR SELECTING THEM

A. Introduction

An entrepreneur can choose to conduct business in several different ways; e.g., as a corporation, partnership, or LLC. One of the marvels of modern business law is the increased flexibility of business organizations. Assuming, for example, that the absence of an entrepreneur's limited liability is a traditional hallmark of doing business as a partnership, business may be done through a partnership—a limited partnership—which limits the liability of some (but not all) partners. Or, if centralized management, as manifested through governance of the business by a board of directors, reveals the presence of a corporation, business may be done in a corporation without centralized management—a close corporation.14

All forms of doing business are grounded in state law. For example, the laws—indeed, the statutory laws—of Illinois, prescribe how a corporation is formed, its owners' rights and obligations, etc.; other statutes bestow life on other forms of doing business, such as partnerships and LLCs. (This article uses Illinois law as a guide to those entities; it merely represents what is commonly available in other jurisdictions.) It would be glib, and wrong, to suggest that choices among these entities can be divorced from how they are taxed under federal income tax law; the Illinois statutes necessarily cannot address the federal taxation of the various types of entities, but these tax consequences must be considered each time the form of an entity is selected. Both laws' effects must be examined.

The link between state and federal law notwithstanding, this section of the article focuses solely on the state law advantages and disadvantages of doing business in a particular form, and the following section addresses the federal income tax consequences of the choice of entity.

B. Different Forms of Doing Business

Several entities are available to someone wishing to conduct business. For example, a person about to engage in business can organize a corporation, under the Business Corporation Act of 1983.15 A corporation is organized by the corporation's incorporators by filing articles of incorporation with the Secretary

14. For the traditional hallmarks of a corporation and a partnership, as well as discussion of limited partnerships and close corporations, see infra Section II.B.

of State, who then issues a certificate of incorporation.\textsuperscript{16} Once a corporation is organized, it usually has a perpetual life.\textsuperscript{17}

Broad latitude is given to the corporation to issue its stock, which may be common or preferred. A corporation's ability to issue a variety of stock, as well as to borrow money, is often why it is perceived as being able to sustain a sophisticated capital structure.\textsuperscript{18} For example, if an impoverished entrepreneur can persuade a wealthy relative to invest in her corporation, the corporation could issue preferred stock to the relative, with a higher and more secure dividend or payment at dissolution, and without the right to vote. The corporation could issue common stock to the entrepreneur which, in turn, could lead to a less secure dividend or payment at dissolution, but which possesses the right to vote and to share more fully in the corporation's hoped-for growth.

The liability of the corporation's shareholders is limited to paying "full consideration" for the stock.\textsuperscript{19} Furthermore, should the corporation borrow, or perhaps even become insolvent, the shareholders might not be paid dividends, which only can be paid if the corporation is not rendered insolvent and the payment does not lead the corporation to have net assets less than the amount payable to preferred shareholders upon liquidation.\textsuperscript{20} When a corporation dissolves, its creditors are paid before its shareholders, and its preferred shareholders typically are paid before its common shareholders.\textsuperscript{21} Especially when contrasted with partnerships, which require the partners to be personally responsible for the partnership's debts, the limited liability of a corporation's shareholders becomes attractive. While the statutes are silent, distributions must be equal among shareholders. In other words, the same dividend (or distribution in dissolution of the corporation) must be paid on each share of a class of stock. If two shareholders each own ten shares of a corporation's common stock and $100 is paid to one of these shareholders with respect to her stock, then $100 also must be paid to the other shareholder.\textsuperscript{22}

Owners of stock that possess the right to vote ordinarily vote to elect people to the corporation's board of directors or on major corporate acts, such as their corporation's merger into another corporation or dissolution of the corporation.\textsuperscript{23}

\textsuperscript{16} 805 Ill. Comp. Stat. 5/2.05, 2.10, 2.15 (West 1997).
\textsuperscript{17} See id. § 2.10(d).
\textsuperscript{18} See generally David R. Herwitz, Allocation of Stock Between Services and Capital in the Organization of a Close Corporation, 75 Harv. L. Rev. 1098 (1962).
\textsuperscript{19} See 805 Ill. Comp. Stat. 5/6.40 (West 1997).
\textsuperscript{20} See id. § 9.10.
\textsuperscript{21} See id. § 12.30.
\textsuperscript{23} See, e.g., 805 Ill. Comp. Stat. 5/7.40 (cumulative or straight voting of shares to elect directors); §§ 7.85 (vote required for certain business combinations), 11.20 (same for merger, consolidation, or share exchange), 12.15 (vote on dissolution) (West 1997). See also §§ 2A.05-2A.60 (corporation may be close corporation, the primary benefit of which is to operate without directors).
The shareholders' ability to vote notwithstanding, the power and authority to run the business vests in the directors.24

An entrepreneur also can engage in business through a partnership under the Illinois Uniform Partnership Act.25 A general partnership is less formal than a corporation, and arises when “two or more persons” associate “to carry on as co-owners a business for profit.”26 Once two or more persons have formed a partnership, each “partner is an agent of the partnership for the purpose of its business, and the act of every partner . . . binds the partnership.”27 Furthermore, the partnership is liable for the acts of a partner so that, for example, if a partner incurs a debt in behalf of the partnership or injures a third party while engaging in partnership business, the partnership will be liable for the resulting debt the same as the partner would have been.28 In turn, the partners are jointly and severally liable for the obligations of a partner for which the partnership is liable, as well as for the partnership’s other debts and obligations.29 A partner’s property rights in a partnership include her right to participate in the management of the partnership.30 A partnership can be dissolved very easily; e.g., by the death or bankruptcy of a partner and, more generally, when a partner ceases “to be associated in the carrying on . . . of the business” of the partnership.31 A person may not become a member of a partnership without the consent of all of the partners,32 thus, interests in a partnership are not freely transferable. Unlike two equal shareholders, who each must receive equivalent distributions with respect to their stock, two equal partners may receive different distributions with respect to their partnership interests.33

Much of what distinguishes a partnership from a corporation may be understood by contrasting the two types of entities. For example, the unlimited liability of a partner for the partnership’s debts, the relatively limited life of a partnership, the diffusion of management in a partnership, and the inability to freely transfer partnership interests all become more apparent when contrasted with a corporation.34

\[
\begin{align*}
24 & \quad \text{See id. § 8.05.} \\
26 & \quad \text{Id. § 9(1).} \\
27 & \quad \text{See id. § 13.} \\
28 & \quad \text{Sec id. § 15.} \\
29 & \quad \text{See id. § 24.} \\
30 & \quad \text{See id. §§ 31, 29.} \\
31 & \quad \text{See id. § 18(g).} \\
32 & \quad \text{See id. § 18 ("rights . . . of partners . . . shall be determined, subject to any agreement between them. . . ."). See also § 26 (partner's partnership interest includes her share of profits).} \\
33 & \quad \text{Illinois also permits business to be conducted through a limited partnership. 805 Ill. Comp. 210/100-210/1205 (West 1997) (Illinois Revised Uniform Limited Partnership Act).} 
\end{align*}
\]
Illinois also permits business to be conducted through a *limited liability company* under the Limited Liability Company Act. As with a corporation, an LLC is formed by filing a formal document, the articles of organization, with the Secretary of State. Somewhat like a corporation, and somewhat like a partnership, LLCs have members, and those members share in the management of the LLC; they may, however, elect to vest control in managers. As in a partnership, unanimous consent ordinarily is required to admit new members to an LLC. Also as in a partnership, members of an LLC may allocate profits and losses as they wish; absent a contrary agreement, however, allocation will be according to the book value of the member's membership interest in the LLC. Unlike the partnership provisions, the liability of a member of an LLC for the LLC's obligations is limited to her investment in the LLC.

III. FEDERAL INCOME TAX CONSEQUENCES OF THE DIFFERENT TYPES OF ENTITIES: TAXING PROFITS, DISTRIBUTIONS, AND LIQUIDATIONS

A. Introduction

Taxation of business transformations cannot be understood without also understanding the taxation of businesses as they make a profit, make distributions to their owners, and as they liquidate. These are the paradigms for taxing a business. If the transformation of a business is to be taxed, these modes of taxation become important for understanding how to impose a tax.

Basic topographical landmarks sketch the federal income taxation of business entities. For example, the three ways in which gross income can be taxed are as ordinary income, capital gain, or not at all. This triptych prevails, regardless of the entity being scrutinized. Through early 1997, the maximum rates imposed on these types of income, if the taxpayer was an individual, were 39.6% on ordinary income, 28% on capital gain, and 0% on excluded income or unrecognized gain. The maximum rates imposed on these types of income, if the

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35. 805 Ill. Comp. Stat. 180/1 (West 1997). Illinois also permits business to be done as a limited liability partnership. See id. §§ 6 (partnership defined to include a limited liability partnership), 8.1 (definition of an LLP).
36. See id. §§ 5-1, 5-5.
37. See id. § 15-1.
38. See id. § 10-1. See also id. § 30-5 (when assignment is made without unanimous consent, assignee ordinarily has no right to participate in LLC's management or to become a member).
39. See id. § 20-10. See also id. § 20-15 (similar rules for sharing in distributions).
40. See I.R.C. §§ 1(a)-(e) (ordinary income), 1(h) (capital gain) (1997). See, e.g., § 351(a) (transferor of property to controlled corporation does not recognize gain or loss).

The Taxpayer Relief Act of 1997 wrought substantial changes on individuals' capital gains. The maximum rate on sales after May 6, 1997 may be no more than 20% and, ultimately, the maximum rate may be no more than 18%. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 789 (1997).
taxpayer is a corporation, are 35% if the income is ordinary income or capital gain, and 0% if the item is excluded income or unrecognized gain; rates on capital gain have since been reduced.41 Because the rates differ on each type of income, characterization of income is very important.

For example, all three types of income are reflected in the way property received by a shareholder from a corporation is taxed to her under Section 301(c). This section treats distributions from a C corporation to a shareholder with respect to her stock as a dividend (ordinary income), a return of basis (exclusion from income), or income from the sale or exchange of property (capital gain).42 While an individual shareholder would prefer receiving capital gain to a dividend in order to reduce her tax, a corporate shareholder would prefer receiving a dividend to capital gain in order to reduce tax because a dividend is taxed to a corporation at a lower rate than capital gain.43

Furthermore, a “double tax” is often said to be imposed on C corporations because the profits are taxed to the corporation when earned and again taxed to the shareholders when distributed to them. Thus, the double tax is a reason to avoid doing business as a C corporation. While it is not entirely accurate to suggest that taxpayers should always avoid doing business as a C corporation, this statement highlights the tax stakes involved in the choice of an entity. A maximum 35% tax is currently imposed on a corporation’s taxable income.44

The differential between this maximum corporate tax rate—35%—and the maximum tax imposed on a corporation’s shareholder, such as an individual—39.6%—leads to one of two results. On the one hand, if the entrepreneur does business through a C corporation and has the corporation distribute all of its income to her, doing business through the corporation will lead to more tax than doing business outside of a corporation. On the other hand, however, if the entrepreneur does business through a C corporation but has the corporation

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Nor is the current complexity of the capital gains tax the only complexity that has ever visited the area. For a brief history of this area, see generally Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶¶ 50.1, 50.2.3, 50.3.1 (2d ed. 1990).

41. See I.R.C. §§ 11 (ordinary income), 1201 (capital gain) (1997) and, for example, the nonrecognition provision noted in the prior note.

42. See I.R.C. § 301(c) (1997) (reflects all three types of income, respectively, in §§ 301(c)(1), 301(c)(2), and 301(c)(3)). See also United States v. Generes, 405 U.S. 93, 92 S. Ct. 827, reh'g denied, 405 U.S. 1033, 92 S. Ct. 1274 (1972) (indicates the difficulty most taxpayers have in characterizing stock as anything other than a capital asset; therefore, if taxpayer holds stock as capital asset, I.R.C. § 301(c)(3) probably leads to capital gain or loss).

43. Corporations are currently allowed to deduct 70% of the dividends they receive from other corporations under Section 243, so that the maximum tax on an intercompany dividend is 10.5%, while the maximum tax on corporate capital gains is 35%. Compare I.R.C. § 243 (1997) (dividends received deduction) with § 1201 (1997) (maximum 35% tax on a corporation’s capital gain). If a corporation received a $100 distribution subject to Section 243, it would deduct $70 of the distribution and, even if it paid the maximum Section 11 tax on its $30 of taxable income ($100 distribution-$70 deduction), it would pay only $10.50 of tax ($30 x 35%).

44. See I.R.C. § 11 (1997). See also id. § 11(b)(1) (additional 3% or 5% tax imposed on corporation’s taxable income in certain cases).
refrain from distributing its income to her, doing business through the corporation will lead to less tax than doing business without a corporation.\textsuperscript{45}

These results can be illustrated with the following table, which contrasts a business done outside the confines of a C corporation and one operated as a C corporation. In the former case, a proprietorship, S corporation, or partnership (whether or not it is an LLC) would all lead to the same tax result. The only difference between the two modes of taxation is the form of doing business; i.e., as a C corporation or not as a C corporation. Table 1 illustrates extreme situations; it assumes, for example, that the maximum marginal tax rates apply, which will probably not be the case. But such extremities highlight the federal income tax differences between doing business as a corporation and not doing business as a corporation.

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|}
\hline
Z corporation & Business is not C corporation & Business is C corporation \\
\hline
Business taxable income & $1,000 & $1,000 \\
\hline
-§ 11 corporate tax & -$0 & -$350 \\
\hline
after-tax income & $1,000 & $650 \\
\hline
-§ 1 tax & -$396 & -$257 \\
\hline
after-tax income & $604 & $393 \\
\hline
\end{tabular}
\caption{Table 1}
\end{table}

If the corporation distributes all of its income, then a double tax is indeed imposed on the corporation's income and the shareholder will be $211 poorer—$393 after-Section 1 tax as opposed to $604 after-Section 1 tax—for having done business in the corporate form than for doing it in any other form. If, however, the corporation retains its earnings because, for example, the shareholder has enough other income to avoid compelling the corporation to distribute its income, then not only is the second shareholder-level tax not

\textsuperscript{45.} That the corporation's retention of its profits can diminish overall tax has led Congress to enact provisions that compel the corporation to disgorge these profits. The two most notable provisions are the accumulated earnings tax and the personal holding company tax. See generally Jeffrey L. Kwall, \textit{Subchapter G of the Internal Revenue Code: Crusade Without a Cause?}, 5 Va. Tax Rev. 223 (1985) (reviews both taxes). Retention of profits also will lead to increased value of stock of the corporation when the corporation is liquidated or its stock or assets are sold. A shareholder will receive capital gain when she has the corporation liquidated or sells her stock. See I.R.C. §§ 331, 1221 (1997). A corporation will probably have a mixture of ordinary income or capital gain when it sells its assets, depending on whether it holds a particular asset as a capital asset or not. See \textit{id.} § 1221; Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) (sale of partnership fragmented into sale of capital assets and other assets).
imposed, but she is $46 richer—$650 after-Section 11 tax income as opposed to $604 after-Section 1 tax income—for having done business as a C corporation. The rates for entities that are not C corporations are also reflected in the income taxed to owners of businesses that are S corporations and partnerships. The business’ income is not taxed if it is one of these two entities, and so it is taxed only to the business’ owners. In the above example, the after-tax income would be $604.

The following portions of Section III of this article explain how profits earned by different entities are taxed and how liquidations of these entities are taxed. While all three types of entities—C corporations, S corporations, and partnerships—are discussed, they might be more easily understood as two more general types of entities—C corporations, and then the other two entities. Distinct, different schemes govern S corporations and partnerships, but they conceptually share the same base because both are “pass-through entities”; i.e., businesses that are not taxed but whose owners are.

Several reasons exist for the ensuing discussion of the taxation of profits, distributions, and liquidations. This analysis helps one to understand the tax reasons for which different entities are chosen and to explain how business transformations are taxed if nonrecognition is not available. Because the article proposes amending the Code to permit corporations to be transformed into partnerships without the recognition of gain or loss, this explanation also describes the framework into which such nonrecognition would fit. It cannot be underscored strongly enough that taxation of these entities are complex subjects, and that the following review only skims the surface, analyzing only what is necessary to further the understanding of the proposal advanced by this article.46

B. Taxing a C Corporation

1. Taxing a C Corporation’s Profits

Unlike all other business entities, a C corporation is a taxpayer and is taxable on its profits. Other entities have significance for federal income tax purposes,


Possible alternatives to the current taxation of pass-through entities, for example, S corporations and partnerships, are explored in American Law Institute, Federal Income Taxation Project: Taxation of Pass-Through Entities, Memoranda Nos. 1, 2 (1995, 1996).

Shortly after I received galleys for this article, I also received the ALI’s third memorandum on pass-through entities, Tax Advisory Group Draft No. 22 (1998). It addresses conversion from one type of entity into another more than the earlier memoranda and, in some cases, would treat the conversions as liquidations. I would like to acknowledge the draft, but cannot comment on it at this late date other than to note its publication and to urge readers to consider it.
but none of them are taxed. A C corporation’s profits are also taxed in the hands of their owners, but only when these profits are distributed.47

Once the corporation’s profits are taxed to it under Section 11, it may or may not distribute those profits—less the tax it paid on them—to its shareholders. The consequence of this distribution is described by the right-hand column in Table 1. After tax, the corporation’s profits available for distribution amount to $650. What happens then? Since 1913, “dividends” have been taxed.48 And, since 1916, dividends have been defined as any distribution out of a corporation’s earnings and profits.49 Section 301 is the lynchpin to answering this question, because Section 301 taxes shareholders on a “distribution,” including a dividend. Without a distribution, there is no shareholder tax. Thus, if the $650 is not distributed, the shareholders are not taxed on it. If it is distributed, they probably are taxed on it because the corporation probably has earnings and profits, so that the distribution is a dividend. The intent of this scheme is to preserve the nature of the corporation’s profits when they are placed in the shareholders’ hands and, because the profits continue to be profits, to tax them as such when they have been received by the shareholders.

More specifically, Section 301(c)(1) taxes a shareholder on a distribution which is a “dividend.” In turn, Section 316 defines a dividend as a distribution of property made from the corporation’s “earnings and profits,” whether the earnings and profits have been earned in the taxable year when the distribution is made or accumulated in an earlier year.50 The device found in the Code to distinguish the distribution of profits—and profits are always taxed under the Code—and other distributions—which may not be taxed because they are not profits—are earnings and profits.51

47. The statutes under which a C corporation and its shareholders are taxed include I.R.C. §§ 11, 301, 312, 316 (1997). See generally Bittker & Eustice, supra note 46, at Chs. 5 (taxation of C corporation) and 8 (taxation of shareholders); Daniel M. Schneider, Taxation of Dividends and Corporate Distributions Chs. 4, 7 (1994) (same).

Other entities may be taxed in discrete circumstances. See, e.g., I.R.C. §§ 1374, 1375, 1363(d) (1997) (taxes imposed on S corporation and not its shareholders). And S corporations and partnerships do have independent significance for tax purposes, even though they are not generally taxed. For example, they must make certain elections and calculate their taxable income. See I.R.C. §§ 1363(c)(1), 703(b) (elections, respectively, by S corporations and partnerships), 1363(b), 703(a) (taxable income, respectively, of S corporations and partnerships) (1997).


51. As stated in Luckman v. Commissioner:

As [the term “earnings and profits” is] used in federal taxation, this concept represents an
Once a corporation has distributed property to a shareholder, she is taxed under Section 301(c). As noted above, the distribution can be taxed in one of three manners, as a dividend, a return of basis, or a capital gain. Taxation of distributions can be illustrated with the following example.

Example 1. Taxpayer A invested $1,000 in Corporation X in 1994. During that year, X had earnings and profits of $600. Assuming that X has no earnings and profits during 1995, if X distributes $500 to A in 1995, A has a $500 dividend; if X distributes $750, A has a $600 dividend and a $150 return of basis; if X distributes $1,625, then A has a $600 dividend, a $1,000 return of basis, and $25 of capital gain.

Returning to Table 1, it is apparent that doing business as a C corporation is more expensive—by about twenty-one percentage points—than not doing business in that manner, if the business distributes all of its after-tax taxable income to its shareholders. If a corporation does not distribute that income, however, doing business as a C corporation is actually less costly—by about five percentage points—than not doing business as a C corporation.

Why do business in a C corporation if the shareholders demand the distribution of profits to them? The greater tax imposed upon C corporations that distribute their profits has led to numerous proposals to "integrate" the corporate and shareholder taxes on income so that only one tax is imposed. Until integration becomes the law, however, it would appear to be less costly to attempt to separate those corporate distributions with respect to stock which represent returns of capital contributed by the stockholders from those distributions which represent gain derived from the initial investment by virtue of the conduct of business. The crucial issue is whether a given transaction has a real effect upon the portion of corporate net worth which is not representative of contributed capital and which results from its conduct of business. In order to make this determination it is necessary to scrutinize the economic effects of the particular transaction as well as its character and relationship to the corporate business.

418 F.2d 381, 383 (7th Cir. 1969). Earnings and profits are calculated under I.R.C. § 312 (1997), by modifying the corporation's taxable income. See also Rudick, supra note 50, at 879-80.

52. See supra text accompanying note 42.

53. $604 after-tax income in non-C corporate business v. $393 after-tax income in C corporation (60.4% v. 39.3%).

54. $650 after-tax income in C corporation v. $604 after-tax income in non-C corporate business (65% v. 60.4%).

55. The two primary proposals either exclude from a shareholder's income dividends upon which the corporation has already paid tax or credit a shareholder with the tax paid respect to dividends paid to her. See generally Treasury Department, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992) (exclusion model); ALI, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration (1993) (credit model); Bittker & Eustice, supra note 46, ¶ 1.08 (discusses integration proposals); Schneider, supra note 47, ¶ 1.03 (same); Colloquium on Corporate Integration, 47 Tax L. Rev. 427-723 (Spring 1992).
do business as an S corporation or as a partnership, as is explained below, than as a C corporation.

Doing business as a C corporation, however, need not be costly. First, if the corporation does not distribute its profits, the second shareholder-level tax is not imposed. Even if profits must be distributed to the corporation’s shareholders, tax can still be minimized. For example, if the C corporation’s taxable income in Table 1 were $0, then no corporate tax would be imposed under Section 11 and the shareholder’s taxable income would be $604, the same as if she had not done business as a C corporation, because no corporate-level tax has been imposed. While a corporation’s profits and, therefore, its income cannot be negated, its deductions might be increased. A corporation cannot deduct dividends paid to shareholders, but it can deduct other expenses if the Code allows the expense as a deduction. Thus, taxpayers and their lawyers have spent substantial energy trying to characterize corporate payments made to shareholders as deductible expenses, most notably salary to shareholders who also are corporate employees, interest on loans from the shareholders to the corporation, or rent on property owned by shareholders and leased to the corporation. In turn, the Internal Revenue Service has resisted the corporation’s deduction of such expenses, characterizing these payments instead as “constructive dividends.”

Even if a corporation can avoid characterization of payments to its shareholders as constructive dividends, it is still difficult to completely negate the double tax imposed on the income of C corporations. Deductions may not be stretched to match exactly the amount of the corporation’s taxable income. At best, a corporation may only approximate its deductions and its gross income. Until corporate and shareholder taxes are integrated, if ever, taxpayers will resort to other forms of business in order to minimize tax. Of course, business reasons also may compel taxpayers to do business as an S corporation or as a partnership.

2. Taxing a C Corporation’s Distributions and Liquidation

Both during the course of its life and when it terminates, a corporation may distribute property instead of cash. Whether it distributes property in liquidation or not, it is taxed on the distribution because that distribution also comprises its “disposition” of property under Section 1001. Distributions and liquidations are not inevitably entwined, but they both contrast with the taxation of a corporation’s profits. Therefore, both are discussed below.

56. See infra Section III.C, III.D.

57. A corporation’s accumulation of its profits may be subjected to one of two penalty taxes, the accumulated profits tax and the personal holding company tax. See supra note 45.

58. See, e.g., Charles Schneider & Co. v. Commissioner, 500 F.2d 148 (8th Cir. 1974), cert. denied, 420 U.S. 908, 95 S. Ct. 826 (1975) (contingent compensation treated as constructive dividend); Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Cl. Ct. 1970) (compensation treated as constructive dividend). See generally Schneider, supra note 47, ¶ 5.05.
The normal course of a C corporation's life, that its profits are taxed to it and again, as it distributes these profits—or, more specifically, its earnings and profits—to its shareholders, is disrupted when it liquidates. Assuming that it has not distributed all of its profits to its shareholders before this termination of business, what happens? Several theoretical possibilities present themselves, ranging from somehow taxing the as-of-yet undistributed earnings and profits to the shareholders as ordinary income, to taxing the shareholders and completely ignoring these earnings and profits. The former would result in ordinary income, and the latter approach in capital gain. The former approach analogizes the liquidation to a distribution, albeit now a final one, of the retained profits not yet taxed to the shareholders, while the other likens the transaction to a sale of stock, in which case, of course, the taxpayer would obtain capital gain or loss from the disposition of the stock, which she undoubtedly holds as a capital asset. In fact, the Code likens a liquidation distribution to a sale, because the shareholder obtains capital gain or loss when exchanging her stock with the corporation for a distribution of property at the time of liquidation. Capital gain or loss arises because Section 331(a) provides that a distribution made in liquidation is treated as "full payment in exchange for the stock." Assuming, as is probably the case, that a shareholder holds her stock as a capital asset, the existence of an exchange enables the shareholder to obtain capital gain or loss. Congress' analogy of a liquidation to a sale was intentional; a statement to this effect exists in the legislative history of Section 331's predecessor. Another aspect of liquidations—a troublesome aspect—was addressed in 1986 when Congress repealed the statutory embodiment of the General Utilities doctrine. In General Utilities, the Supreme Court had held that a corporation was not taxed when it distributed property to a shareholder. This was of obvious

59. Under state law, such as Act 5, supra note 4, §§ 12.05 to -.85, the corporation dissolves; under the Code, it liquidates. See Treas. Reg. § 1.332-2(c) (1960) (describes when liquidation occurs).

A traditional lure of C corporations has been that a taxpayer can transform ordinary income into capital gain. Her share of the corporation's profits, if they are distributed to her, lead to ordinary income. See supra Section III.B.1. In contrast, gain from the sale of stock probably leads to capital gain because the shareholder probably holds the stock as a capital asset. See supra note 42. And the value of her stock is enhanced by the profits the corporation retains. Impediments also exist to converting ordinary income from stock into capital gain. See, e.g., I.R.C. §§ 306 (preferred stock bailouts), 341 (collapsible corporations) (1997).


61. See supra note 42.

62. See I.R.C. § 1222 (1997) (capital gain and loss defined to exist when sale or exchange of capital asset occurs).

63. See S. Rep. No. 68-398, at 11 (1924), reprinted in 1939-2 C.B. 266, 274 (a "liquidating dividend is, in effect, a sale by the stockholder of his stock to the corporation").

benefit to corporations and shareholders if the corporation distributed appreciated property to its shareholders. The corporation would realize, but not recognize, gain, and the shareholders would obtain a basis in the property distributed equal to its fair market value. The appreciation would have been taxed only if the corporation were taxed—which it was not, because of *General Utilities*—or because the shareholders assumed the corporation’s basis in the property—which they did not.

Indeed, the *General Utilities* doctrine was codified in 1954, when Congress enacted Section 311(a) and former Section 336(a). These sections provided that a corporation would not recognize gain or loss it had realized in nonliquidating and liquidating distributions. Inroads were made into the taxation of nonliquidating distributions, as Section 311(b) was widened to tax the corporation on gain from such distributions in an increasing number of circumstances. Congress became distraught enough with the codification of the doctrine that it changed course in 1986, by rendering distributions of appreciated (but not depreciated) property into recognition events by the corporation; Sections 311(b) and 336(a) were amended to this end. Now, only if the shareholder is a corporation that controls the liquidating corporation is gain or loss realized in the distribution by the liquidating corporation not recognized by it under Section 337.

Thus, as the law now stands, corporate distributions of appreciated property are taxed to the corporation, whether the distribution is in liquidation or not, but not when liquidation distributions are made to a controlling corporate parent shareholder.

C. Taxing an S Corporation

1. Taxing an S Corporation’s Profits

Unlike a C corporation, an S corporation is not taxed on its profits. Only its shareholders are taxed on the corporation’s profits. This result is reached

65. See I.R.C. §§ 1001 (gain or loss realized usually recognized as well), 301(d) (basis of property received in nonliquidating distribution), 334(a) (basis of property received in liquidating distribution) (1997).

66. See also I.R.C. § 337(a) (1997) (before amendment in 1986) (corporation did not recognize gain realized in certain sales made pursuant to adoption of its plan of liquidation).


68. But see infra note 71 (S corporation taxed in certain situations). Using the figures set forth in Table 1, an S corporation’s shareholders’ tax would be the $396 tax described in the left-hand column, resulting in an after-tax income of $604.
through an intricate set of statutory rules. First, Section 1363(a) provides that
the corporation is not taxed. It must, however, compute its taxable income under
Section 1363(b). This enables the shareholders to determine their aliquot share
of the corporation's income, deductions, and other tax items, on each of which
they are taxed pursuant to Section 1366(a)(1). Finally, to prevent the sharehold-
ers from being taxed again on corporate income already taxed to them, or from
benefiting twice from deductions already allocated to them, Section 1367(a)
requires that shareholders adjust the basis of their stock upwards for income
allocated to them, and downward for deductions allocated to them or distribu-
tions actually made to them.69 A shareholder also may deduct the losses
allocable to her under Section 1366(d), but only to the extent that she has basis
in her stock or loans to the corporation equaling or exceeding the losses.

2. Taxing an S Corporation's Distributions and Liquidation

An S corporation, like a C corporation, may distribute property in lieu of
cash. A distribution of property is a recognition event to a C corporation, and it
is to an S corporation as well.70 However, because an S corporation is not
taxable, the gain it realizes and recognizes when it makes a distribution, even in
liquidation, simply is and must be taxed to its shareholders, not to it.

Distributions of appreciated property are taxable because of Congress'
elimination of General Utilities from the Code in 1986. Because an S
corporation is not taxable, and because C corporations are taxed, Congress
imposed a tax under Section 1374 on S corporations that formerly had been C
corporations if they had "built-in gains." Without Section 1374, a C corporation
might make an S election shortly before it distributed property and, because it
would be an S corporation when it made the distribution, no corporate-level tax
would be imposed. Thus, Congress imposed the Section 1374 tax on an S
corporation's "built-in gains." The tax is imposed only on an S corporation that
formerly was a C corporation.71

The same rules govern liquidation of C and S corporations.72 Therefore,
an S corporation shareholder obtains exchange status under Section 331 as she
surrenders her stock to the S corporation in exchange for a final distribution from
the corporation. The corporation is taxed on its distribution of property to the
shareholder, recognizing whatever gain or loss it has realized, although such gain

69. See also I.R.C. § 1366(b) (1997) (character of items determined at corporate, not
shareholder level; therefore, if corporation sells capital asset, shareholder has capital gain, even if the
same asset would not have been a capital asset in the shareholder's hands).

70. See I.R.C. §§ 311(b) (distributing corporation must recognize gain in distributions to which
§§ 301-307 apply), 336(a) (corporation must recognize gain in liquidating distributions), 1371(a)(1)
(except as otherwise provided, "subchapter C shall apply to an S corporation and its shareholders");
subchapter C includes §§ 311 and 336) (1997).


72. See supra Section 11I.B.2.
or loss is passed on to its shareholders. One difference between liquidations of S and C corporations is that a shareholder's basis in the stock of an S corporation fluctuates as the corporation's income and deductions were attributed to her and as distributions were made to her, while a shareholder's basis in the stock of a C corporation more probably was fixed by her original contribution. Presumably, a distribution in liquidation would trigger Section 1374. Gain would be recognized by the corporation even if Section 1374 had not been enacted, but Section 1374's presence subjects the corporation to tax as well.

D. Taxing a Partnership or LLC's Profits and Distributions

Like an S corporation, a partnership is not taxed. A partnership's income and deductions are taxed to its partners, and their bases in their partnership interests are adjusted upward, or downward, for the income and deductions allocated to them and for the distributions made to them. Different provisions apply to partnerships than S corporations, however, and they are noted below. An LLC usually is treated as a partnership for federal income tax purposes, and the following discussion encompasses both entities.

First, partners, and not the partnership, are taxed pursuant to Section 701. A partnership must calculate its taxable income, under Section 703, and that taxable income is included in the partners' taxable income under Section 706 "for any taxable year of the partnership ending within or with the taxable year of the partner." A partner may deduct her share of the partnership's losses, assuming that she has a basis in her partnership interest that at least equals the

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73. See infra note 134.
74. See supra note 72. On the corporation's exposure to Section 1374, see Eustice & Kuntz, supra note 46, ¶ 13.03[8][d].


76. Treasury Regulation § 1.701-2 gives the Commissioner of the Internal Revenue Service broad powers to prevent abuse of the partnership tax rules. These regulations have been criticized. See generally McKee et al (summary and criticism of the regulation), supra note 46. Because termination of a partnership is not germane to the thesis of this article—that corporation-partnership conversions not be taxed—it will not be discussed.
77. See I.R.C. § 702(b) (1997) (character of items in partner's distributive share determined at partnership, not partner, level; therefore, if partnership sells a capital asset, partner has capital gain, even if the same asset would not have been a capital asset in the partner's hands).
losses she would deduct. She is taxed on her share of a partnership's profits and losses according to her "distributive share" of the partnership's income, deductions, etc. Section 702 taxes each partner on her distributive share of such tax items and, in turn, Section 704 sets forth how a partner calculates her distributive share.

A partner avoids double taxation of partnership profits by adjusting her basis in her partnership interest under Section 705 upwards for her share of income allocable to her, and downwards for her share of losses allocable to her and for distributions made to her.

Sections 731-733 govern the taxation of partnership distributions. The overall effect of these sections is to try to avoid taxing the partnership or the partner during the course of a distribution. In turn, distributions may be broken down into distributions of money and distributions of property other than money.

Distributions of property other than money are never taxed. Section 731(b) provides that the partnership does not recognize gain or loss in a distribution. Section 731(a) provides that the partner is not taxed either. Under Sections 732 and 733, the partner takes the partnership's basis in the property distributed to it or, if less, her basis in her partnership interest. Her basis in her partnership interest after the distribution is whatever her basis was in the interest before, less the basis she took in the distributed property.

The effect of these sections is to postpone taxation on the gain or loss inherent in the property until the partner disposes of the property in a taxable manner. Distributions reduce basis, and a distribution in excess of basis can

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79. Ordinarily, I.R.C. section 704(a) requires that a partner's distributive share be determined by the partnership agreement. If, however, the distributive share under the partnership agreement, "does not have substantial economic effect," then Section 704(b) provides that the partner's distributive share is determined in accordance with her interest in the partnership. For example, three equal partners may agree that each has a one-third interest in the partnership's income and deductions. They also could agree to "specially allocate" a disproportionate amount of income to one of them and a disproportionate amount of deductions to another. If either special allocation lacks "substantial economic effect," Section 704(b) requires allocations on the basis of the three partners' interests in the partnership, presumably, one-third of the income or one-third of the losses to each.
80. See also I.R.C. § 735 (governs character of gain or loss on partner's disposition of property distributed to her); § 734 (optional basis adjustment for partnership property) (1997).
81. Consider the following example.

Example. Partner A's basis in her partnership interest is $1,000. The partnership distributes property to her, with a fair market value of $400, in which its basis is $300. The partnership is not taxed on the distribution, nor is A. A's basis in the property distributed to her is $300, and her basis in the partnership is reduced to $700.

See I.R.C. §§ 1001(a), (c), 731(b) (1997). The partnership realizes but does not recognize $100 gain when it distributes the property to A. A realizes and recognizes $100 gain if and when she sells the property, for example, to a third party, assuming that the property's fair market value did not change. See id. §§ 1001(a), (c). If the partnership's basis in the property had been $1,150, and the property been worth $1,350, for example, then A's basis in the property after its distribution to her would have been $1,000. Were she to sell the property, she would have gain of $350—$200 from the property itself, given the difference between the partnership's basis in the property and its fair market value,
lead to gain. This distribution in excess of basis, however, is not currently taxed. Instead, the distribution in excess of basis is taxed later, by means of reducing a partner's basis in the property distributed to her, so that the subsequent sale will increase gain or reduce loss attributable to the sale.

When a partnership distributes cash to a partner, the partnership avoids taxation under Section 731(b). Section 731(a)(1) provides that the partner is not taxed, unless the amount of money distributed to her exceeds her basis in her partnership interest. The gain is taxed under Section 731(a) as arising from a sale or exchange, such that the partner, who probably holds her partnership interest as a capital asset, has capital gain. As is true of property distributions, under Section 733(1) cash distributions reduce the partner's basis in the partnership, but not below zero.

IV. FEDERAL INCOME TAX CONSEQUENCES OF THE DIFFERENT TYPES OF ENTITIES: THE CURRENT TAXATION OF TRANSFORMATIONS

A. Introduction

Businesses are transformed during the course of their lives in a variety of ways; e.g., as they organize an entity through which to operate, reorganize internally, or acquire or are acquired by other businesses. Taxation of these transformations is the subject of this section of the article.

Exclusive of a termination of a business, transformations tend to be taxed similarly, regardless of the type of entity involved. Foremost among these similarities is that the gain or loss realized by parties to the transaction is not recognized and that "carryover" or "substituted" basis attaches to the property so transferred. Nonrecognition and the concomitant carryover or substitution of basis mean that a taxpayer does not pay tax on the gain or loss she has "realized" in the transformation and that her "basis" in the property received is such that, assuming that values of property do not change, she will take into account during a later sale an amount equal to the previously realized but "unrecognized" gain or loss. C and S corporations' transformations tend to be taxed alike, their primary difference arising from the different ways in which their income and shareholders are taxed. Partnership transformations are taxed differently from corporate transformations.

An overview of the taxation of nonterminating business transformations and the general allowance of nonrecognition is set forth below. Because the transformation of a corporation into a partnership is the focus of this article, the

and $150 from the difference between the partnership's basis in the property and her basis in the partnership.

82. See, e.g., I.R.C. §§ 732(a)(1) (partnership's distribution of cash to partner in excess of her basis in partnership interest); cf. 301(c)(3) (1997) (corporation's distribution to shareholder in excess of her basis in stock).

83. Loss is recognized only upon distributions in liquidation. I.R.C. § 731(a)(2) (1997).
breadth of corporate transformations, from organization through reorganization, is examined. The organization of partnerships is the only partnership transformation reviewed because this transformation involves the organization of a partnership; the others, such as mergers of partnerships into one another, are not pertinent. Nonrecognition is pervasive among transformations and a reading of this portion of the article underscores that point. If nonrecognition is not available in a transformation, some other model—such as the taxation of an entity’s profits or taxing the entity as if it has liquidated—must govern. How to tax the transformation of a corporation into a partnership, in turn, and whether nonrecognition or the taxation of profits is the more appropriate model, becomes the topic of the following section of this article.

B. Choice of Taxable Entity

1. Introduction

Entrepreneurs must choose the form in which they do business whenever they begin operations. As suggested above, different needs can compel use of different entities. Recent changes in the rules governing choice of entity will lead to greater use of LLCs and, in turn, increase pressure on entrepreneurs doing business through S corporations to convert their corporations into LLCs. Therefore, choice of entity is discussed below.

Choice of entity is heavily influenced by the federal income taxation of the entity and its owners. Because the taxation of an entity depends upon what type of entity it is—corporate income is “taxed” twice; partnerships and S corporations are pass-through entities whose income is taxed only once in the hands of their owners84—characterization is very important. Furthermore, the probability, or at least the possibility, that businesses tend to distribute much of their income to owners (who, like the rest of us, must pay daily expenses), suggests the probable adversarial positions of the Internal Revenue Service and taxpayers when disputes about characterization arise. The Service will try to characterize an entity as a corporation (or, in the terms of older regulations, an “association ... taxable as a corporation”85) and owners will try to characterize it as a pass-through entity because the former type of entity leads to two taxes on business income, the latter to only one tax.

The federal taxation of the entity chosen is affected by underlying state law. Clearly, whether an entity is a corporation (or partnership, etc.) for federal income tax purposes is a function of federal, not state, law. Nevertheless, a business usually organizes as a corporation (or partnership, etc.) under state, not federal, law.86 The interplay between federal and state law has given rise to

84. See supra notes 68, 75.
86. See supra Section II.
relatively formal procedures of choosing entities under federal income tax law and to substantial expenditures of energy by lawyers, courts, and the Internal Revenue Service in their attempts to meet or defeat these formalities.

The federal income tax rules guiding the choice of entity fall into two broad periods of time, for which 1995 is a watershed year. Both eras are discussed below.

2. The Old Rules: Morrissey and Old Regulation Section 301.7701

The traditional gate through which one must pass in order to begin characterizing entities for federal income tax purposes under Section 7701 has been *Morrissey v. Commissioner.* There, the Supreme Court addressed the proper characterization of an entity organized as a trust, an active trust that was engaged in business. Under its regulations interpreting a predecessor of Section 7701, the Commissioner’s view was that business trusts were associations. In turn, federal tax law defined corporations to include associations, therefore, this business trust should be taxed as a corporation, according to the Commissioner. To the Court, associations and corporations resembled one another, and an association was simply one type of corporation. The Court concluded that both types of entities possessed centralized management, continuity of existence, free transferability of interests, and limited liability. Associations also tended to have multiple associates and to carry on a business. Thus, the Supreme Court concluded that the trust in *Morrissey* was taxable as a corporation.

In 1954, in *United States v. Kintner,* several doctors successfully characterized their partnership operating in Montana as an association. The Treasury Department responded to *Kintner* in 1960 by promulgating new regulations about the characterization of entities under Section 7701 that theoretically made it more difficult for an entity to be characterized as a corporation. These regulations demoted the last two of the six *Morrissey* factors noted above because they were true of all organizations engaged in business, and required that an entity

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89. Two Revenue Acts were at issue, but both had the same definition of a corporation. Revenue Act of 1924, § 2(a)(2), 43 Stat. 253 (1924), and Revenue Act of 1926, § 2(a)(2), 44 Stat. 9 (1926).
90. Id. at 357.
92. 216 F.2d 418 (9th Cir. 1954). This enabled them to obtain pensions unavailable to them if their partnership were not taxed as an association.
93. See generally McKee et al., supra note 46, ¶ 3.06.
possess more of the other four corporate characteristics than not in order to be characterized as an association.95 These "old" Section 7701 regulations were in effect until superceded by new Section 7701 regulations promulgated in 1997.96

Morrissey, Kintner, and the old Section 7701 regulations form the benchmarks for the older manner in which the form of an entity was chosen. These standards were relatively formal, in that entrepreneurs could shape their entities to possess or avoid the various corporate characteristics.97 Because partnership income is subject to a single tax, entrepreneurs frequently sought to avoid characterizing their businesses as associations taxable as corporations,98 especially as limited partnerships became more popular throughout the 1960s, 1970s, and 1980s.

3. The New Rules: Notice 95-14 and New Regulation Section 301.7701

In 1995, the Internal Revenue Service changed its approach to characterizing entities by issuing Notice 95-14 and promulgating, in 1997, new regulations under Section 7701.99 These two authorities permit a business to choose its form of doing business for federal income tax purposes if it has not been incorporated.

Several currents in business practices surrounded the Service's new approach. For example, the choice of entity has never diminished in importance or in perplexity. Because no uniform tax rate is imposed on all taxpayers, there has always been some tax benefit to doing business in one form and not in another. The rates might change and, therefore, one form may be advantageous, but the historic differences between rates has always led to one form of doing

97. See, e.g., Zuckman v. United States, 524 F.2d 729 (Cl. Ct. 1975) (taxpayers able to establish that limited partnership under state law also was partnership under federal income tax laws); Larson v. Comm'r, 66 T.C. 159 (1976), acq. 1979-2 C.B.1, 2 (same).
98. See, e.g., supra note 24.
Thus, for example, the Kintner regulations provided some standard against which to measure entities—unincorporated businesses tended not to be characterized as corporations—but they certainly did not render the choice of entity moot.

The Kintner regulations then haunted the Service by making it easier for businesses to avoid C corporation status; e.g., by being permitted to possess as many corporate as noncorporate characteristics without being characterized as a corporation.101 The tax shelter industry prospered, at least in part, because of this ease with which entities could organize as partnerships, specifically limited partnerships.102 Deductions flowed through to the limited partners and, if these deductions came without substantial economic cost (e.g., because they consisted of depreciation deductions on property which partnerships had purchased for “excessive” amounts of nonrecourse debt and in which they therefore had inflated bases), tax shelters could become only more, not less, popular. Substantial inroads into curbing tax shelters were made, culminating in limiting a taxpayer’s deduction of losses derived from passive activity losses, which included the typical tax shelter, to the extent that she had gains from other passive activity losses.103 Tax shelters were attacked on other fronts as well by Congress, courts, and the Service.104

Curtailment of the excesses of tax shelters, however, did not render the choice-of-entity question moot. The underlying tax—and business—factors always made one form of entity most attractive, even if the factors varied over time. In the late 1980s, however, the Service began to acknowledge the status

100. For example, since 1993, the maximum tax rate on an individual’s taxable income has been 39.6% and the maximum tax rate on a corporation’s taxable income has been 35% (except for an additional 5% tax rate imposed on corporations with certain taxable incomes). See I.R.C. §§ 1, 11 (1997). Before 1986, the maximum tax rate on these taxable incomes were 50% and 46%, respectively. See id. §§ 1 (before amendment in 1986), 11 (same). Table 1 reveals the consequence of the current taxation and, while the figures would differ, also reveal the import of pre-1987 taxation as well. Between 1986 and 1993, however, the maximum respective taxes were 28%-31%, on the one hand, and 35%, on the other. See id. §§ 1 (after amendment in 1986), 11 (same). Then, doing business as a C corporation would never have led to less tax than doing business in some other manner, because even if a corporation retained all of its after-tax income, that income could amount only to 65% of pre-tax income. In contrast, if a business did not operate as a C corporation, its owners’ after-tax income would have amounted to 69% or more of the business’ pre-tax income.

The maximum tax on capital gains also has varied, and this too affected and continues to affect choice of entity. See supra note 40.

101. See supra text accompanying note 95.

102. See generally General Explanation, supra note 67, at 209-14 (sets forth background to curbs imposed on tax shelters by Congress in 1986).


104. See, e.g., I.R.C. §§ 465 (at-risk limitation to amount of deductible losses); 7704 (1997) (publicly traded/master limited partnerships); Commissioner v. Tufts, 461 U.S. 300, 103 S. Ct. 1826, reh’g denied, 463 U.S. 1215, 103 S. Ct. 3555 (1983) (nonrecourse debt included in cost basis of property, even if it exceeds property’s value); Estate of Franklin v. Comm’r, 544 F.2d 1045 (9th Cir. 1976) (limited partners failed to prove value of property was not inflated, so that they were not able to take depreciation and interest deductions attributable to the property).
of LLCs as partnerships for tax purposes, beginning with a 1988 revenue ruling.\textsuperscript{105} Furthermore, LLCs were extraordinarily attractive because they offered the best of both worlds: the limited liability available to corporations under state law, and the pass-through taxation of income and deductions to their owners available under federal income tax law.

The Service announced its intent to simplify the Section 7701 regulations that classified entities for federal income tax purposes by publishing Notice 95-14.\textsuperscript{106} It perceived the historical differences between corporations and partnerships to be fading as state legislatures modified these traditional forms. Continued expenditures of resources for characterizing entities under federal tax law was not merited, especially in light of the diminishing differences between them under state law. The Service indicated its intent to limit simplification of the regulations to domestic unincorporated businesses if it had at least two owners. (Requiring the entity to have at least two owners enabled the Service to avoid dealing with whether a partnership could have only one owner, a position the Service resists.)\textsuperscript{107} It believed that "domestic unincorporated business organizations typically are formed to obtain partnership classification; [therefore, it intended that] those organizations generally would be classified as partnerships for federal tax purposes unless the organization [sic] file an election to be classified as an association taxable as a corporation."\textsuperscript{108} Thus, the Notice did not address characterization of incorporated entities nor did it address characterization of foreign unincorporated entities.

\textsuperscript{105} See Rev. Rul. 88-76, 1988-2 C.B. 360 (LLC under Wyoming law treated as partnership for tax purposes). See also I.R.S. Notice 95-14, 1995-1 C.B. 297, where the Service states:

The existing classification regulations are based on the historical differences under local law between partnerships and corporations. However, many states recently have revised their statutes . . . thereby narrowing considerably the traditional distinctions between corporations and partnerships.

One consequence of the narrowing of the differences under local law between corporations and partnerships is that taxpayers can achieve partnership tax classification for a nonpublicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation. Taxpayers and the Service, however, continue to expend considerable resources in determining the proper classification of domestic unincorporated business organizations.

\textsuperscript{106} See \textit{supra} note 105. The Service's ability to issue regulations to effectuate this policy has been questioned as being a matter more properly within the purview of Congress. See, e.g., Dougan et al., \textit{supra} note 99; Heidi Glenn, \textit{JCT To Go Public About Private Meetings}, 73 Tax Notes 1007 (1996) (Joint Committee of Taxation Counsel Kies questions propriety of Service's promulgation of check-the-box regulations); Staff of Joint Comm. Tax'n, Review of Selected Entity Classification and Partnership Tax Issues II (Joint Comm. Tax'n 1997) (same). For deference paid to regulations, see generally Michael Asimow, \textit{Public Participation in the Adoption of Temporary Tax Regulations}, 44 Tax Law. 343 (1991); Bernard Wolfman, Note, \textit{Supreme Court Decisions in Taxation: 1980 Term}, 35 Tax Law. 443 (1982).

\textsuperscript{107} See, e.g., Treas. Reg. § 301.7701-2(c)(1) (as amended in 1997) (requires partnership to have at least two owners).

\textsuperscript{108} I.R.S. Notice 95-14, 1995-1 C.B. 297.
In May 1996, the Service proposed regulations under Section 7701 that followed up on Notice 95-14, and final regulations were promulgated in January 1997. The final regulations abandon the formal Morrissey criteria, and simply permit a domestic business entity, if it is not incorporated, to choose how it will be subject to federal income tax.

Regulation section 301.7701-1 distinguishes between business entities that create a “separate entity” for federal income tax purposes and those that do not. Although phrased awkwardly, separate entity status might be explained as follows. An individual has an identity as a taxpayer. She also may carry on a business. Is that business a “separate entity” from her individual tax status? Only if the answer to this question is “yes” must further inquiry be made into the character of that entity. A separate entity arises when the parties carry on a business and divide the profits from that business, such as when co-owners of an apartment building both lease space and provide services to the tenants. If there is no separate entity, then some other characterization of the taxpayer must prevail. If there is no business, there cannot be a separate entity; for example, no separate entity exists when two persons engage in a joint undertaking to share expenses, to construct a drainage ditch, or merely co-own property, because their actions do not rise to the level of a business. (Similar examples in the old regulations were used to distinguish certain organizations from a partnership.) Presumably, they are simply two individuals, each taxed separately. An entity owned by just one person can elect whether to be treated as a separate entity. However, once an organization is recognized as a separate entity for federal income tax purposes, then its character may be assessed under the remaining Section 7701 regulations.

An entity that is a separate entity is a business entity if it is not characterized as a trust for federal income tax purposes. And, if this business entity has at least two members, it must be treated as a partnership or as a corporation for federal income tax purposes. What distinguishes a corporation from a partnership? To some extent, the regulations set forth entities that must be characterized as corporations, such as a business entity wholly owned by a state or a political subdivision of a state. Perhaps the most significant entity to be characterized as a corporation, however, is a business entity organized as a

111. See id.
112. See old Reg. § 301.7701-3(a) (as amended in 1977).
116. See id.
corporation under federal or state law. Thus, state law remains important in characterizing entities under the proposed regulations even if it is not determinative. In other words, a business organized as a corporation under state law inevitably will be treated as a corporation under federal income tax law as well.

What is a partnership? In a facile manner, it is an entity that is not a corporation. It also must have two members. If the multiple-owner entity escapes automatic characterization as a corporation under the rules noted in the prior paragraph, it is a partnership. It may secure a particular character, however, by electing that character. A multiple-owner entity may affirmatively elect to be treated as a corporation or as a partnership, and will be taxed in whatever form it has elected. Absent such an election, it will be treated as a partnership. Thus, an entity wishing to be taxed as a partnership presumably does nothing. If it wishes to be taxed as a corporation or to change its characterization, then it makes an election.

Once the taxable form in which an entrepreneur does business is established, the consequences of transforming that business may be explored. Those consequences are now reviewed.

C. Corporate Transformations

1. Introduction

Corporations can be transformed without terminating in a variety of ways. For example, businesses are incorporated or are reorganized as they acquire another corporation's stock or assets or as their stock or assets are acquired by another corporation. All of these transformations escape taxation because gain or loss realized in such a transformation is not recognized. The exception to this rule is that the gain or loss realized in the conversion of a corporation into a partnership is recognized. With the simultaneous increase in popularity of LLCs and decrease in popularity of S corporations, taxation of this last type of corporate transformation becomes more important. The thesis of this article is that it is not appropriate to tax corporate conversions into partnerships, but the rationale for this point of view lies in how other corporate transformations escape taxation. Therefore, taxation of corporate transformations are reviewed below. As was true of the taxation of profits analyzed above, this portion of the article

120. See id.
only sketches how corporate transformations are taxed, and is not intended to exhaust the subject.\(^\text{124}\)

2. Organization: Section 351

   a. Statutory Overview

   Every incorporation of a business either falls within or without Section 351. If Section 351 applies, then a shareholder's transfer of property to a corporation—in which she necessarily must realize gain or loss—is not a recognition event, and so she does not take the gain or loss into account for tax purposes. Generally, Section 351(a) applies when a person who transfers property to a corporation receives solely stock of the corporation in exchange for her property; Section 351(b) applies if she receives other property; e.g., cash or boot, in addition to the stock. Both sections are mandatory in their application. If Section 351(a) applies, no gain or loss "shall" be recognized; if Section 351(b) applies, gain "shall" be recognized.

   For purposes of Section 351, little difference exists between the organization of a C and an S corporation. S corporations may have no more than seventy-five shareholders who, for example, must be U.S. citizens or residents,\(^\text{125}\) and these shareholders must own only common stock; no such limits are imposed on C corporations. But, assuming that the typical situation surrounding the organization of a corporation is that relatively few persons come together, perhaps with a business, with skills, and with money,\(^\text{126}\) and acquire only common stock, then these differences are meaningless and certainly not problematic.\(^\text{127}\)

\(\text{124}\) See generally Bittker & Eustice, supra note 46, chs. 3 (organizations), 11 (divisions), and 12 (reorganizations). The American Law Institute has drawn somewhat finer distinctions than the following discussion in the text. It was concerned more specifically with the future of taxation of pass-through entities, and tended to emphasize the greater flexibility available to contributions to partnerships than S corporations, but for which the price was greater statutory constraints on abuse of the rules surrounding contributions to partnerships than S corporations. See ALI Memorandum No. 2, supra note 46, at 127-44.


\(\text{126}\) Cf. Susan M. Wittman, S Corporation Returns, 1994, 16 SOI Bull. 38 (Spring 1997) (notes large number of S corporations in 1994 with few shareholders; e.g., over 81% of all S corporations filing returns in 1994 only had one or two shareholders); Hamill, supra note 13 (discusses amount of corporations' assets, not number of corporations' shareholders); ALI Memorandum No. 2, supra note 46, at 11-18 (discusses composition of small businesses).

\(\text{127}\) Cf. Rev. Rul. 77-220, 1977-1 C.B. 263 (single business organized as three separate S corporations in order to avoid limit on number of shareholders S corporation was permitted to have, and then three corporations formed partnership to do business; held, corporations stepped together and S corporation status denied because they exceeded permissible number of shareholders). Rev. Rul. 77-220 was revoked by Rev. Rul. 94-73, 1994-2 C.B. 198 (election of separate S corporations respected). See generally Bruce N. Lemons and Richard D. Blau, Significant Issues May Remain for S Corporation Partners Despite IRS's Newest Ruling, 81 J. Tax'n 132 (1994) (discusses Rev. Rul. 94-43).
Thereafter, the same Section 351 limitations apply to a corporation, whether it is a C or an S corporation.

Section 351(a) has three essential elements. First, one or more persons must transfer property to a corporation. Next, this transfer must be solely in exchange for stock of the corporation. Finally, the persons who transferred property to the corporation must "control" the corporation immediately after the exchange. Control is defined in greater detail by Section 368(c), and occurs when the stock owned by the transferors possesses at least eighty percent of the total combined voting power of the corporation and at least eighty percent of all other classes of stock of the corporation.128

Despite the statutory contours of Section 351(a)'s application, much of the area is governed by case law and Internal Revenue Service rulings and regulations.129 Section 351's nonrecognition is of greatest benefit to investors seeking to avoid tax triggered by the disposition of appreciated property they have contributed to the corporation. The section is less important to taxpayers who have no appreciation upon which to avoid taxation, such as those who contribute money, and is shunned by taxpayers contributing depreciated property to corporations who would like to recognize the losses they have realized.

Investors can receive property back from a corporation in addition to the corporation's stock. They could receive debt of the corporation, cash, or other property, such as property another investor has contributed or property the corporation purchased on its own (property frequently called "boot"). Technically, Section 351(a) does not apply because the investor has received something other than the corporation's stock. Section 351(b)(1), however, applies because the other two elements of Section 351(a) are met—persons have transferred

128. Section 351(a)'s application can be illustrated with the following example.
Example. Individuals A and B each transfer $10,000 to a new corporation, Corporation X, in exchange for all of X's stock. Each person takes back 50 shares of X's stock in the exchange, and retains it.
All the elements of I.R.C. section 351(a) are met. A and B have transferred property to the corporation. The sole consideration given to them by X is stock. Because A and B also own all of the stock of the corporation, they possess control and, because they do not dispose of the stock immediately after they receive it, given these sparse facts, they have control immediately after the exchange.
But see I.R.C. § 351(e) (1997) (situations in which Section 351 does not apply, such as transfer to investment company).
129. For example, cash is treated as property pursuant to cases such as Holstein v. Commissioner, 23 T.C. 923 (1955), and whether the transferors have control immediately after the exchange is determined largely by case law, with the transferor's binding obligation to dispose of stock even as she acquires it being the determinative factor whether she possesses such control. See, e.g., D'Angelo Assocs. v. Commissioner, 70 T.C. 121 (1978), acq. in result 1979-2 C.B.1 (voluntary transfer to other family members; held, control existed immediately after transfer); Manhattan Bldg. Co. v. Commissioner, 27 T.C. 1032 (1957), acq. 1957-2 C.B.5 (pre-existing commitment to transfer stock; held, no control existed immediately after transfer); American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920, 70 S. Ct. 622 (1950) (same).
property to a corporation and control it immediately after the contribution—and requires the investor to recognize gain to the extent that she has received boot. 130

One particular variation of the tax consequences of a shareholder’s receipt of boot occurs when she contributes property to a corporation which is subject to a liability, either on a recourse or nonrecourse basis. Generally, a taxpayer’s being relieved of debt generates income for her, 131 and the same would be true even when that relief occurs during the course of a contribution of property to a corporation. 132 In this latter circumstance, Section 357(a) provides that gain realized by the investor is not recognized. 133

If a transfer of property does not fall within either Sections 351(a) or 351(b) because the transfer fails to meet one or more of the subsections’ requirements, then Section 351 does not apply. A transferor will then recognize whatever gain or loss she realizes in the exchange.

The converse of a Section 351 exchange is the taxation of the corporation organized by the transferor. Section 1032 governs the corporation, and generally provides that it will not recognize whatever gain or loss it may realize when it exchanges its stock with persons for property they contribute to it.

If Sections 351 and 1032 apply, then the amount of gain or loss not recognized by a shareholder when she contributes property to the corporation, or by the corporation when it issues stock to her, ideally should be taken into account at some future time. Assuming that the property is still worth what it was when it was contributed, the stock the shareholder received in the exchange, as well as the property she contributed to the corporation, will possess bases that force this later accounting. This is because Section 358 provides that a shareholder’s basis in the stock received equals her basis in the surrendered property, less the fair market value of other property received in the exchange, plus gain recognized in the exchange. The corporation’s basis in the property

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130. For example, if A in supra note 128 contributed her appreciated property (basis $1,000, fair market value $10,000), and received cash of $2,500 and stock worth $7,500, she would be required to recognize $2,500 of the $9,000 gain she realized. If she received X’s note for $3,000 and stock worth $7,000, she would be required to recognize $3,000 of the $9,000 gain she has realized. If B had contributed her depreciated property (basis $15,000, fair market value $10,000), and received cash of $2,500 and stock worth $7,500, Section 351(b)(2) provides that she would be unable to recognize any of the $5,000 loss she has realized. The gain recognized can never exceed the gain realized. See Bittker & Eustice, supra note 46, ¶ 3.05(1).

131. See I.R.C. § 61(a)(12) (1997) (cancellation of indebtedness is gross income); see also I.R.C. § 108(a) (1997) (circumstances in which cancellation of indebtedness is excluded from gross income).


133. For example, assuming that A in supra note 128 contributed property in which her basis was $1,000 and which was worth $10,000, and which was subject to a nonrecourse mortgage of $3,000, if X assumed the $3,000 mortgage, the consideration A receives would be assumption of the debt and stock worth $7,000. Section 357(a) provides that A would recognize none of her $9,000 gain. See I.R.C. § 357(a) (1997).
acquired is determined under Section 362(a), not Section 358, but some analogy to Section 358 does exist. Section 362(a) provides that the corporation's basis of property received in a Section 351 exchange equals the transferor's basis plus whatever gain the transferor recognized in the exchange. Section 362(a) also compels the recognition of an amount equal to the formerly unrecognized gain or loss with respect to the property.\textsuperscript{134}

Property transfers generally trigger assignment of income questions, and property transferred pursuant to Section 351 is no exception to this rule. As just noted, Sections 351 and 1032 sanction formal assignments of appreciation or depreciation with respect to property; e.g., imbuing property received in a Section 351 exchange with a basis that compels the later recognition of an amount of gain or loss at least theoretically equal to the gain or loss not recognized in the exchange. Beyond that, case law and revenue rulings tend to set forth the law in the area. General assignment-of-income principles dictate, for example, that the taxpayer who earns income be taxed on it or that the taxpayer who pays an expense deduct it. Therefore, a taxpayer ordinarily cannot assign the income or the deduction to someone else. Assignment-of-income principles prevail in corporate tax as well; thus, the types of issues addressed by this nonstatutory authority are whether the transferor or the corporation in a Section 351 transaction is the correct taxpayer to take the right to receive income, to take a deduction, or to take the tax benefit from a previous deduction which has now been disallowed. Generally, courts have attempted to continue to promote Section 351's goal of encouraging businesses to incorporate through nonrecognition of gain or loss by taxing a transferor's right to receive income to the corporation, not to the transferor.\textsuperscript{135}

\textsuperscript{134} The paragraph in the text can be illustrated with the following example.

\textit{Example.} Individual $A$ transfers property in which her basis is $100$ and the fair market value of which is $500$ to a new corporation, Corporation $X$, in exchange for all of $X$'s stock.

I.R.C. §§ 351 and 1032 apply to $A$ and to $X$. See I.R.C. §§ 351, 1032 (1997). Under Section 358, $A$'s basis in her stock is the same $100$ as her basis in the property surrendered in the exchange. Thus, she will recognize the same amount of gain, $400$, when she sells the stock—assuming that it is worth $500$ at the time of the sale—as she would have had she recognized the $400$ gain when she disposed of the property. If the stock is worth more when she sells it, she would recognize more; e.g., if the stock were worth $800$ at the time of the sale, she would realize and recognize $700$. If it is worth less, she will recognize less gain, i.e., only what she has realized; for example, if the stock were worth $300$, she would realize and therefore recognize only $200$. $X$'s basis in the property would be $100$ and if and when $X$ sold the property, e.g., for $500$, it would realize and recognize $400$ gain, the same amount of gain $A$ did not recognize when she transferred the property to $X$. But see I.R.C. § 351(F) (1997) (corporation may recognize gain).


\textsuperscript{135} See, e.g., Hempt Bros., Inc. v. United States, 490 F.2d 1172 (3d Cir.), \textit{cert. denied}, 419 U.S. 826, 95 S. Ct. 44 (1974) (corporation, not transferor, taxed on collection of accounts receivable transferred by transferor); Rev. Rul. 80-198, 1980-2 C.B. 113 (transferor transferred operating assets
b. Policy

Several considerations gird Section 351 and, indeed, related sections. As already noted, gain or loss is "realized" under Section 1001(a) whenever property is sold or otherwise disposed of. Thus, if a merchant transfers goods to customers in the usual course of her business in exchange for money, check, or a charge on a credit card, she realizes gain or loss because, in common parlance as well as under the Code, she has sold property. However, she may engage in other transactions resulting in a similar surrender of her interest in the property, such as the property's exchange with someone else for another piece of property or abandonment of the property. The latter two transactions may not be "sales" of property, but they are other "dispositions" and so, just as if the merchant had sold the property, she realizes gain or loss in these other transactions.

Once a taxpayer has realized gain or loss, she also must ordinarily recognize it. Recognition is not necessarily good or bad. Usually, a taxpayer does not want to recognize gain, because that ordinarily increases her gross income and, therefore, her tax.136 Similarly, she probably does want to recognize loss because losses are deductible and deductions ordinarily reduce taxable income and, therefore, tax.137 On the other hand, an investor who qualifies her contribution of appreciated property—e.g., basis of $100, fair market value of $300—to a corporation under Section 351(a) will obtain a basis in the stock received in the exchange so that, if she sold the stock before its value changed...
from the value it had when she received it, she will realize and recognize gain equal to the amount she did not recognize because of Section 351.138 Other aspects of a taxpayer's tax profile may lead to other goals. For example, a taxpayer with numerous deductions in a given tax year may not feel compelled to realize and recognize a loss in that year because she could not deduct that loss, having already reduced her taxable income to $0.139 And a taxpayer may wish to realize and recognize capital gain if, for example, she has capital losses which she may deduct against these gains.140

Assuming that a taxpayer decides to avoid recognizing gain or loss, what events are characterized as nonrecognition transactions? Nonrecognition events are set forth specifically in the Code and include, for example, transfers to or by corporations under Sections 351 and 1032,141 and transfers to or from partnerships under Section 721.142 But these nonrecognition events do not simply arise. Instead, something must connect these otherwise disparate transactions. Under the regulations to a now-repealed section—Section 1002143—the nonrecognition provisions:

describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated . . . .144

Thus, while Section 351 bears specifically on the contribution of property to corporations, it also is part of the larger galaxy of all nonrecognition statutes. And specific policies underlying Section 351145 are found in the legislative

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138. Under Section 358, her basis in the stock will be $100, and she would realize and recognize $200 gain if she sold the stock for $300 immediately after receiving it. See supra note 134.

139. A taxpayer may deduct losses in excess of income, only to the extent that both arise from business. Such a net operating loss may be deducted against income in other years under Section 172. But personal deductions cannot be allowed in excess of income, whether in the year in which incurred or in another year.


141. See supra Section IV.C.2.

142. See supra Section IV.D.2.


144. Treas. Reg. § 1.1002-1(c) (1960) (emphasis added).

events that spawned the first several nonrecognition statutes, including Section
351.

A version of the Revenue Act of 1918 that preceded the law that was
enacted\textsuperscript{146} provided that gain or loss be recognized when properties were
exchanged in the amount of the fair market value of the property received. If
enacted, this recognition rule would have been subject to two exceptions, for
contributions of property to a corporation and for the merger or consolidation of
corporations.\textsuperscript{147} Only nonrecognition for mergers and consolidations survived the
legislative process to become part of the revenue laws.\textsuperscript{148} Thus, the earliest
version of Section 351 was proposed, but not enacted. Three years later,
Congress enacted a more general recognition provision, also with nonrecognition
exceptions, in the Revenue Act of 1921.\textsuperscript{149} Gain or loss upon the disposition
of property was recognized if the property had a "readily realizable market
value."\textsuperscript{150} Recognition would not occur, even if the property exchanged had a
readily realizable market value, if it was exchanged for like property, for stock
or securities in a corporate reorganization, or upon the transfer of property to a
controlled corporation.\textsuperscript{151}

The Senate Finance Committee report on this 1921 legislation states that the
law sets forth:

new rules for those exchanges or "trades" in which, although a technical
"gain" may be realized under the present law, the taxpayer actually
realizes no cash profit.

Under existing law "when property is exchanged for other property,
the property received in exchange shall, for the purpose of determining
gain or loss, be treated as the equivalent of cash to the amount of its
fair market value, if any." Probably no part of the present income tax
law has been productive of so much uncertainty or has more seriously

\textit{Implications of Contributions of Appreciated and Depreciated Property to Partnerships. Subchapter
C Corporations and Subchapter S Corporations in Exchange for Ownership Interests}, 31 Tax L. Rev.
29 (1975).

Other material about Section 351 includes Daniel N. Shaviro, \textit{An Efficiency Analysis of Realization
(discusses nonrecognition, especially upon contributions to corporations); Curtis J. Berger, \textit{Whither
Partnership Taxation?}, 47 Tax L. Rev. 105, 159-60 (1991) (would eliminate control aspect of
Section 351). For other material about nonrecognition generally, see Bittker & Lokken, supra note
40, at Ch. 44; Marjorie E. Kornhauser, \textit{Section 1031: We Don't Need Another Hero}, 60 S. Cal. L.

147. See S. Rep. 65-617, at 5-6 (1918), \textit{reprinted} in 1939-1 (Pt. 2) C.B. 117, 120.
1097, at 44-45 (1918), \textit{reprinted} in 1939-1 C.B. (Pt. 2) 130, 132.
150. \textit{Id.} at § 202(c).
151. \textit{Id.} at §§ 202(c)(1)-202(c)(3). These provisions are the predecessors of today's I.R.C.
sections 1031, 368 (and related statutes), and 351.
interfered with necessary business readjustments. The existing law makes a presumption in favor of taxation. The proposed act modifies that presumption by providing that in the case of an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value, and specifies in addition certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value. These classes comprise the cases where productive property (other than stock in trade or property held primarily for sale) used in a trade or business is exchanged for property of a like kind or use; where in any corporate reorganization or readjustment stock or securities are exchanged for stock or securities of a corporation which is a party to or results from such reorganization; and where an individual or individuals transfer property to a corporation and after such transfer are in control of such corporation.

The preceding amendments, if adopted, will, by removing uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with the readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges."  

Thus, Congress believed that the law with which it was faced compelled the recognition of gain where no real profit had been generated. Changes in the law would remove uncertainty and "permit business to go forward with the readjustments required by existing conditions."

As can be seen, legislative history suggests that nonrecognition was introduced into corporate organizations in order to promote the ordinary operations of businesses. Granting nonrecognition to investors as they organized corporations or as they contributed more capital to corporations would enable them to avoid tax on purely paper profits as they transferred assets from one personal pocket to another corporate pocket. Entrepreneurs might well organize corporations, but why not encourage them to do so by permitting them to avoid paying tax upon incorporation? The uncertainty surrounding how these events would be taxed seems to have long since disappeared (or at least been replaced by other uncertainties), given the use now of Section 1001(b)'s "amount realized" instead of a "readily realized market value," but avoiding the taxation of paper profits and enabling businesses to engage in readjustments seem as relevant today as they did when proposed as reasons for changing the law in 1921.  

The requirement that persons who transfer property to a corporation control the corporation immediately after the transfer, if Section 351 is to apply and nonrecognition to be granted, is problematic. In contrast, for example, transfers of property to a partnership operate more easily because the transferors need not control the partnership after the transfer if Section 721 is to apply and nonrecognition is to be granted there. Control exists in Section 351 exchanges under Section 368(c) when the amount of stock the transferors own consists of at least eighty percent of the total combined voting power of all the stock of a corporation and at least eighty percent of all other classes of stock in the corporation. Why was eighty percent chosen by Congress to demark the difference between recognition and nonrecognition in Section 351 transfers? Gain or loss is usually taxed when property is sold because the gain or loss realized is also recognized. To the extent that gain or loss realized is not recognized, then the transaction must be distinguishable from a taxable sale. Therefore, Congress differentiated between a sole transferor, who would receive all of a corporation’s stock upon transferring property to a corporation, and multiple transferors. The former easily qualifies under Section 351, whether she contributes all or some of her business, or one or numerous pieces of property, to a corporation. Her interests continue, undiluted by other transferors’ interests in the corporation. What the transferor owned directly, she now owns indirectly; in either case, she owns all of the business. Control is never at issue.

In contrast, any one of several transferors must work in concert with the other transferors in order to qualify under Section 351. For example, two transferors of property of equal value—i.e., two fifty-percent shareholders—must act together to establish control. Ten transferors of property of equal value—i.e., ten ten-percent shareholders—must act together as well, although as many as two of them (who would own exactly twenty percent of the stock) can be excluded from the group’s actions without the other transferors sacrificing control. And when multiple transferors do engage in a Section 351 exchange, they each dilute their sole pre-contribution interest through that interest’s combination with the other transferors’ interests.

Thus, a sole transferor is able to avoid a taxable sale when transferring property to a corporation because she more easily and naturally qualifies under

Other purposes may be served by nonrecognition as well. See, e.g., Jensen, supra note 145 (Section 351 prevents purchases on tax-free basis); Powers, supra note 145 (Section 351 encourages formation of small corporations); Komhauser, supra note 145 (purposes served by Section 1031); David R. Keyser, A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation, 5 Am. J. Tax Pol’y 269 (1986) (argues for taxing appreciation as quickly as possible).

154. See infra note 178.

155. For example, in the common situation where a corporation has only one class of outstanding stock, for example, 100 shares of common stock, control exists when the amount of stock owned is 80 shares or more.

156. See supra note 10.
Section 351. Congress intended that multiple transferors' transfer of property to a corporation be likened more to a taxable sale because of the increasing difficulty, especially as the relative amount of a transferor's post-contribution interest declines (i.e., from seventy-nine percent to one percent). That a difference is drawn between sole and multiple transferors, between transferors owning an overwhelming amount of stock after the transfer and those owning progressively smaller amounts, suggests that Congress intended to honor more than mere changes in the form in which a taxpayer does business. While multiple transferors may qualify under Section 351, they are symbiotically bound together as parts of a whole in a way in which they were not before the transfer.

3. Reorganizations: Section 368

a. Statutory Overview

The taxation of corporate reorganizations parses into three specific areas. First, Section 368 defines the term "reorganization." Second, gain or loss realized by participants in the reorganization, the corporation acquired in the reorganization—the "transferor" corporation—the shareholders of that corporation, and the corporation surviving the reorganization—the "transferee" corporation—is not recognized under Sections 354, 361, and 1032. And third, these participants take a basis in the property they have received—whether stock in the transferee corporation or assets of the transferor corporation—that usually compels the later recognition of an amount of gain or loss equal to the gain or loss not immediately recognized (assuming that values in the property received have not been changed). Sections 358 and 362(b) govern basis.

More specifically, a "reorganization" is a corporate transformation accorded special treatment by the Code. This term is defined by Section 368(a)(1) to include seven types of transformations, such as mergers, stock or assets exchanged for other stock, and insolvency proceedings. All of the reorganizations defined by Section 368(a)(1) have an analogue under state law. For example, Illinois law permits one corporation to merge into another, which is accomplished by the acquiring corporation exchanging its stock or other property for the target corporation's assets and the former corporation's assumption of the latter's debts, if any; this state law transaction is accorded special status under the Code because Section 368(a)(1) defines a reorganization to include a "merger," which, in turn, depends in part upon the transaction's characterization under state law.

158. See Jensen, supra note 145, at 375-96; Powers, supra note 145, at 823-26. Powers also argues that Section 351 is more likely to apply to small corporations.
159. See 805 Ill. Comp. Stat. 5/11 (West 1997) (Illinois law regarding mergers); Treas. Reg. § 1.368-2(b) (as amended in 1986) (defines I.R.C. section 368(a)(1)(A) merger to include transaction that, among other characteristics, is a merger under state law).
As noted above, the earliest definition of a reorganization set forth in the revenue laws was for mergers and consolidations in the Revenue Act of 1918.160 The definition was expanded in 1921 to include stock-for-stock and stock-for-asset exchanges as well.161 Further expansion of Section 368 and its predecessors has occurred since, with many of the changes since 1954 being designed to facilitate the ease with which triangular reorganizations—reorganizations in which either the acquiring or the acquired corporation used a subsidiary to effect the transaction (e.g., by having the subsidiary, not the corporation itself, acquire the assets of the acquired corporation)—could be performed.162

As is also true of Section 351, reorganizations are not pure creatures of statute. Courts have interpreted the meaning of Section 368(a) and its predecessors for many years. For example, even a merger under state law must possess the element of “continuity of proprietary interest” if it is to qualify as a merger that is a reorganization under Section 368(a)(1)(A).163 This continuity requires that the transferor’s shareholders possess a continuing interest in the transferee. They must receive a proprietary interest—stock, not debt, even if it is the transferee’s non-voting preferred stock164—and this interest must constitute a sufficient amount of the total consideration they have received from the transferee; e.g., fifty percent, not sixteen percent, of such consideration.165

Once an exchange has been characterized as a reorganization under Section 368(a), other statutes, such as Sections 354, 1032, and 361, provide that the participants to the exchange ordinarily need not recognize whatever gain or loss they have realized.166

The basic definition of reorganizations is somewhat amplified by Section 368(a)(2). This latter section, for example, permits a corporation to engage in a triangular merger, where the transferor corporation either is acquired by the transferee corporation’s subsidiary—a forward triangular merger, see I.R.C. § 368(a)(2)(D) (1997)—or the transferor corporation survives, by acquiring the subsidiary of the transferee corporation and the transferor’s shareholders end up becoming shareholders of the transferee—a reverse triangular merger, see I.R.C. § 368(a)(2)(E) (1997).

160. See supra text accompanying note 148.


163. See generally Helvering v. Minnesota Tea Co., 296 U.S. 378, 56 S. Ct. 269 (1935); Bittker & Eustice, supra note 46, ¶ 12.21[8]; Schneider & Hoelschen, supra note 162, ¶ 5.02.


165. Compare Rev. Rul. 66-224, 1966-2 C.B. 114 (50% constitutes adequate consideration to qualify transaction as I.R.C. section 368(a)(1)(A) transaction) and Rev. Proc. 77-37, 1977-2 C.B. 568 (Internal Revenue Service will issue advanced ruling that Section 368(a)(1)(A) transaction has occurred if at least 50% of total consideration is transferee’s stock) with Kass v. Commissioner, 60 T.C. 218 (1973), aff’d without opinion, 491 F.2d 749 (3d Cir. 1974) (16% does not constitute sufficient continuity of proprietary interest).

166. Consider this example. Example. Corporation T is merged into Corporation A under state law. A’s sole shareholder, Individual M, exchanges her T stock solely for A stock. M’s basis in her T stock is $500 and, at the time of the exchange, the T stock and the A stock are both worth $10,000.
If the participants in the reorganization do not recognize gain or loss, then they theoretically must obtain a basis in the property they just received that compels them to somehow recognize an equal amount of gain or loss later, assuming that the values of property received do not change.\textsuperscript{167}

\textit{b. Policy}

Little distinguishes the original policy behind reorganizations from the policy underlying transfers to controlled corporations. Both are rooted in early federal income tax law. The stated policy behind reorganizations, as was true of transfers to controlled corporations, was to promote business readjustments, lessen uncertainty, and avoid taxing paper profits.\textsuperscript{168}

Subsequently, however, reorganizations were singled out for further scrutiny, as they received substantial review in 1934. The House Ways and Means Committee was concerned that the provisions governing "exchanges" and "reorganizations" were being used to avoid tax.\textsuperscript{169} The lure of eliminating the

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Under I.R.C. section 1001(a), \textit{M} will realize $9,500 gain as she exchanges her \textit{T} stock for the \textit{M} stock. $9,500 gain realized=$10,000 amount realized-$500 basis in \textit{T} stock. Because she meets Section 354(a), however, she does not recognize this $9,500 gain. Section 354(a) provides that gain or loss is not recognized when stock or securities in a party to a reorganization are exchanged solely for stock or securities of another party to a reorganization, pursuant to a plan of reorganization. Section 368(b) defines a party to a reorganization to include both corporations when one acquires another. Treas. Reg. Section 1.368-1(c) defines a plan of reorganization to:

- contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 368(a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed.

Thus, the elements of Section 354 appear to be met here.

Section 355 provides an analogue to Section 351(b). In other words, if \textit{M} receives cash or boot in addition to \textit{A} stock, she recognizes gain she has realized up to the amount of the boot received. She does not recognize loss under Section 356(c).

\textit{A}'s exchange of its stock with \textit{T} for \textit{T} assets does not lead to \textit{A}'s recognition of gain or loss because Section 1032 prevents a corporation from recognizing gain or loss whenever it exchanges its stock for other property, as \textit{A} does when it exchanges its stock for \textit{T}'s assets.

Finally, \textit{T} may realize gain or loss when it exchanges its assets with \textit{A} for \textit{A} stock. It will not recognize this gain, however, because the transaction also meets the conditions of Section 361. Section 361(a) provides that a corporation that is a party to a reorganization does not recognize gain or loss if it exchanges property with another party to the reorganization in exchange for the latter's stock or securities, if done pursuant to a plan of reorganization. See also I.R.C. § 357(a) (1997) (discharge of debt by acquired corporation does not disqualify transaction from nonrecognition), which is discussed in the context of Section 351, supra note 133. But see I.R.C. § 361(c) (1997) (situations in which taxpayer may recognize gain).

\textsuperscript{167} For example, in the example in the preceding note, \textit{M} realized $9,500 gain. If her basis in the \textit{A} stock were $500—the same basis she had in the \textit{T} stock—and the stock still were worth $10,000 when she sold it, she would be compelled to recognize the same amount of gain she did not recognize in the merger. I.R.C. section 358 achieves this goal, by giving \textit{M} a $500 basis in her \textit{A} stock. For further discussion of I.R.C. § 358 (1997), see supra note 134.

\textsuperscript{168} See supra note 152. See also supra note 153 (other policy considerations).

nonrecognition made available to reorganizations notwithstanding, repeal did not occur. Such an act would severely:

handicap ... legitimate exchanges and reorganizations. Moreover, reorganizations are now being consummated in the majority of cases in order to reduce the capital structure and quite generally show a loss. In the past, the reverse was true, and reorganizations were carried out to expand the capital structure and generally showed a gain . . . . [U]nder present circumstances, the wiser policy is to amend the provisions drastically to stop the known cases of tax avoidance, rather than to eliminate the sections completely. 170

The report continued, proposing two changes, one of which would have limited divisive reorganizations, in order to counter the tax avoidance scheme sought by the taxpayer in the recent cases involving the Gregory taxpayer. 171 The other would have limited the scope of transactions qualifying as reorganizations. The report stated:

By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted. 172

The Senate Finance Committee agreed with the House Ways and Means Committee's concerns about tax avoidance, but did not take such drastic action. 173 It accepted a limit on divisive reorganizations, but rejected any incursion into the definition of reorganizations. 174 The Senate version prevailed. 175 Interestingly, none of the original reasons for gracing reorganizations with nonrecognition were attacked. 176 Thus, it seems reasonable to believe that Congress thought that not taxing paper profits was still a good idea and, furthermore, that permitting business readjustments was important as well.

170. Id. at 12-13, reprinted in 1939-1 (Pt. 2) C.B. 563-564.
171. Gregory v. Helvering, 293 U.S. 465, 55 S. Ct. 266 (1935), was decided by the Supreme Court in the year following the Revenue Act's enactment. But the lower court decisions occurred earlier. See Gregory v. Commissioner, 27 B.T.A. 223 (1932), rev'd sub nom. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934). The Second Circuit decision was affirmed by the Supreme Court, as just noted. The Second Circuit rendered its opinion on March 19, 1934, over a month after the committee published its report. Of course, the Board of Tax Appeals decision was rendered long before the report's publication.
174. See id.
176. Indeed, the Senate committee asserted that reorganizations were being executed "in the majority of cases to reduce the capital structure, and to strengthen the financial condition of the participating corporations." S. Rep. No. 73-558, at 17, reprinted in 1939-1 C.B. (Pt. 2), at 599.
D. Partnership Transformations

1. Introduction

In some ways, taxation of partnership transformations is less formal than the taxation of corporate transformations. Control need not be possessed by transferors of property to partnerships immediately after the exchange; furthermore, the same rule governs both partners and partnerships.

This portion of the article does not address partnership transformations other than organizations because the article's primary focus is on conversions into partnerships. Thus, post-organization partnership events are of relatively little importance to the article. Nevertheless, such transformations occur and are important to the practice of partnership taxation.1

2. Organization: Section 721

a. Statutory Overview

The organization of partnerships is largely governed by three statutes and, as is true of corporate formations, by amplifications thereof by courts and by the Internal Revenue Service. These statutes share some of the themes present in Section 351 and its attendant statutes, viz., nonrecognition of gain or loss realized and basis in property ideally intended to insure the later taxation of an amount equal to the untaxed gain or loss.

The three statutes are Sections 721, 722, and 723. Section 721 provides nonrecognition both to the persons contributing to the partnership and to the partnership, and it does not require that the contributing investors control the partnership immediately after the exchange. Section 722 endows the contributing partner with a basis in the partnership equal to whatever her basis was in the property she contributed. And Section 723 gives the partnership a basis in the contributed property equal to whatever the contributing partner's basis was in the property.178

177. See supra note 12. See generally McKee, et al., supra note 46, chs. 12, 19 (termination of a partnership, and taxation of distributions, including those made in a termination).

178. Consider this example

Example. Individuals A and B decide to form a partnership in which they will be equal 50-50 partners. A contributes $5,000 cash and B contributes equipment for the business in which her basis is $4,500, the fair market value of which is $5,000.

Under I.R.C. section 721, neither A and B nor the partnership will recognize any gain or loss they may realize as they exchange their properties, respectively, for equal partnership interests. Because A is contributing cash, she will not realize any gain or loss, so she does not care whether Section 721 applies. B cares, however, because she has $500 of gain she has realized which she would undoubtedly prefer to avoid recognizing. Section 721 applies, and does apply regardless of whether she has an 80% interest in the partnership, a 50% interest, or a 19% interest. (The latter two figures would lead to different results if the applicable section were Section 351.) See supra note 128. But
These rules regarding the organization of a partnership are supplemented by rules regarding the effect of debt upon an organization. These rules, set forth in Section 752 and accompanying regulations, distinguish between a partner's increase and decrease in her "share of the liabilities of a partnership," and also between recourse and nonrecourse debt which, in turn, affects the amount of her share of a partnership's liabilities.

First, a partner's increase or decrease in her share of the partnership's liabilities is treated by Sections 752(a) and 752(b) as if she has contributed money to, or received money from, the partnership. Under Sections 705 and 722, such a contribution would increase her basis in her partnership interest, and such a distribution would decrease her basis in her partnership interest under Sections 705 and 733.179

Second, the type of debt affects the amount of the debt a partner is considered either to assume or to be relieved of. If the debt is recourse debt, a typical example being the debtor's personal obligation for her car loan or residential mortgage to the creditor,180 then the debtor/partner's share of debt

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see I.R.C. §§ 721(h) (1997) (gain recognized upon transfer to investment company-type partnership); 7704 (publicly-traded partnership treated as corporation, not partnership); Keyser, supra note 153 (tax partnership formation).

Under Section 722, A and B's basis in their partnership interests would be $5,000 and $4,500, respectively. A had no gain to recognize after the contribution, so it stands to reason that she would recognize no gain from the sale of her partnership interest at $5,000 immediately after the partnership's organization. Giving A a basis of $5,000 in her partnership interest achieves this goal. B had $500 of gain in the property she contributed, which she would have both realized and recognized had she sold the property. By contributing it to the partnership, she did not recognize the gain. She will recognize the same amount of gain—$500—if she turns around and immediately resells her partnership interest when she receives it because her amount realized from such a sale, $5,000, exceeds her basis in the interest, $4,500, by $500.

Section 723 gives the partnership a basis in the property it has received equal to the contributing partner's bases in the property. As with Section 362(a), see supra note 134, this prevents negation of Section 721. Whether B, for example, sells her partnership interest or the partnership sells the property B contributed to it, an amount equal to B's unrecognized gain of $500 will be recognized and taxed.

179. These principles can be illustrated with the following example.

Example. Individuals A and B form a partnership, and are equal partners. A contributes property in which her basis is $1,000, and which is worth $3,000. In addition, the property is subject to a $200 liability, of which A is relieved as she makes her contribution. A's basis in her partnership interest, absent the debt, would be the same as her basis in the contributed property, i.e., $1,000. See supra note 178. Whether the debt is recourse or not affects A and B's respective liabilities. The contribution relieves A of a $200 obligation but, because she is a 50% partner, she immediately becomes liable for $100 of the obligation, such that her basis, after application of I.R.C. sections 752(a) and 752(b), is $900. $900=$1,000 basis-$200 decrease in basis (I.R.C. §§ 752(b), 705(a)(2), 733 (1997)) + $100 increase in basis (I.R.C. §§ 752(a), 722, 705(a)(1) (1997)). See also Treas. Reg. § 1.752-1(f) (1991) (when same transaction both increases and decreases liabilities, two consequences must be netted).

is "the portion of that liability, if any, for which the partner ... bears the economic risk of loss." In turn, this economic risk of loss arises, and if the partnership were to constructively liquidate, "the partner ... would be obligated to make a payment to a person ... because that liability becomes due and payable." In contrast, if the debt is not recourse debt, as might occur in a commercial real estate loan, then her share of the debt is determined by her share of the partnership minimum gain, Section 704(c) gain, and excess nonrecourse liabilities in accordance with the partner's share of partnership profits.

Assignment-of-income problems must be considered in connection with the organization of partnerships, just as they were with the organization of corporations. It is perhaps even more problematic here, because assignment of income is an integral part of the structure of partnerships. Most notably, partnerships permit the allocation of income, deductions, and other tax attributes to partners other than in a manner that reflects their ownership interests. The shareholder of a C corporation who owns ten percent of the corporation's stock can expect to receive ten percent of all dividends distributed to its shareholders. Similarly, the shareholder of an S corporation who owns ten percent of the corporation's stock can expect to have taxed to her ten percent of all of the corporation's income, deductions, and other tax attributes. But a ten percent partner may have ten percent, more or less, of the partnership's income taxed to her. She also may have a particular type of income, and all or only some of the partnership's deductions or a particular type of deduction, or other tax attributes taxed to her. All that is necessary under Section 704(b) is that this special allocation have a "substantial economic effect."
Partnerships are inherently more fluid than corporations. As with corporations, once property is transferred to the partnership, income generated by the property is no longer taxed—or taxed directly, at least—to the transferor of the property. The assignment of income has been legitimized in such a way that it is difficult to judge the point at which assignment oversteps its bounds, as illustrated by the recent case of Schneer v. Commissioner. There, a taxpayer who was a partner in a law firm was required to determine whether fees generated because he had been a partner in an old law firm were taxable to him or to the new partnership. With one exception, the fees were earned as he consulted with the old firm's clients, but after he had joined the new firm. In both partnerships, income earned by a partner's professional activities—his or her practice of law—were collected by the partnership and then distributed to each of the partners according to his or her interest in the partnership's profits.

After concluding that the income was earned from an activity similar to the new partnership's activity (i.e., the practice of law), and that the income had not been earned before assignment to the new partnership, the court decided that the old partnership's fees should be taxed to the new partnership, not to the taxpayer. In other words, were the fees derived from the old partnership

187. See supra note 135.
188. More than in the corporate area, many cases surrounding the organization of partnerships differentiate that event from some other nonpartnership transaction, such as lending money to or employing someone else. See generally McKee et al., supra note 46, ¶ 3.03. Assignment of income also arises in partnership tax, see id. ¶¶ 4.02[2], 9.01[5], 19.02[2], and is implicit in any code which permits transactions such as special allocations, supra note 79. But see supra note 76 (anti-abuse regulation).
190. Id. at 657, 658. In doing so, the court observed:

The Internal Revenue Code of 1954 provided the first comprehensive statutory scheme for the tax treatment of partners and partnerships. No section of the 1954 Code, successive amendments or acts, nor the legislative history specifically addresses the treatment of income earned by partners in their individual capacity but which is pooled with other partnership income. It is implicit in subchapter K, however, that the pooling of income and losses of partners was intended by Congress. This question is more easily answered where the partnership contracts with the client for services which are then performed by the partner. The question becomes more complex where the partner contracts and performs the services when he is a partner.

Moreover, no opinion contains a satisfactory rationale as to why partnership pooling agreements do not come within the holding of Lucas v. Earl . . . . The fundamental theme penned by Justice Holmes provides that the individual who earns income is liable for the tax . . . . It is obvious that the partnership, as an abstract entity, does not provide the physical and mental activity that facilitates the process of "earning" income. Only a partner can do so. The income earned is turned over to the partnership due solely to a contractual agreement, i.e., an assignment, in advance, of income.

The pooling of income is essential to the meaningful existence of subchapter K. If partners were not able to share profits in an amount disproportionate to the ratio in which they earned the underlying income, the partnership provisions of the Code would, to some extent, be rendered unnecessary . . . .
fully earned before the taxpayer received them and automatically transferred them to the new partnership, or had he not quite been entitled to them and, thus, effectively assigned them to the new partnership? To the court, the latter approach was the correct answer.

b. Policy

The rationale for not taxing a contribution to a partnership was articulated in 1920 in Solicitor Opinion 42.191 There, the Solicitor of Internal Revenue stated that no gain or loss was realized by a partner contributing property to a partnership; to do otherwise “would be to hold that [a] partner could make a profit by selling to himself.”192 Some relatively early cases also held that contributions of property to a partnership were not realization events.193 It seems arguable that the 1920 Solicitor Opinion was actually in the background when Section 351’s predecessor was eventually enacted in 1921, even though law akin to Section 351 had first been proposed in 1918.194 In any case, the Solicitor Opinion comprised the authority for not taxing organizations of partnerships until enactment of the Internal Revenue Code of 1954 when, for the first time, contributions to a partnership became nonrecognition (not nonrealization) events for the partners and for the partnership in 1954 because of the enactment of Sections 721-723.

Transfers to partnerships are not nearly as problematic as transfers to corporations. Gain or loss realized in any transfer of property by a partner to a partnership is simply not recognized. In contrast, gain or loss realized is not recognized only in those transfers to a corporation in which the transferors control the corporation after the exchange.195 As was noted in connection with

The provisions of subchapter K tacitly imply that the pooling of income is permissible. Said implication may provide sufficient reason to conclude that a partnership should be treated as an entity for the purpose of pooling the income of its partners. Under an entity approach, the income would be considered that of the partnership rather than the partner, even though the partner’s individual efforts may have earned the income. If the partnership is treated as an entity earning the income, then assignment-of-income concepts would not come into play.

Id. at 64. The legislative history of I.R.C. sections 351 and 368 also indicates Congress’ aversion to taxing purely paper profits. See supra note 152.


194. See supra notes 146-149.

195. See supra note 128. But cf. I.R.C. §§ 704(c), 724, 735 (1997) (statutes which relate back...
transfers to corporations, gain or loss realized when property is disposed of that is also recognized is a hallmark of a taxable sale. Therefore, Congress apparently determined that no transfer of property into a partnership ever should be likened to a sale of property. In contrast, transfers to a corporation where transferors did not control the corporation afterwards resembled a sale because they were taxable.

On the other hand, a transfer to a corporation can have a minimal formal effect, as an investor owns indirectly, through the corporation, that which she formerly owned directly. This would be true whether, for example, one person solely incorporated her business or two persons incorporated their businesses and each took back stock proportionate to her investment in the corporation. In contrast, all transfers of property to a partnership necessarily have a more substantial effect, since at least two persons are necessary to form a partnership. What one owned directly before, she can now own only half if she is an equal partner in a two-person partnership, or she can now own only one-third if she is an equal partner in a three-person partnership, etc. As with corporations, however, partners who receive partnership interests proportionate to their investment in the partnership engage in a more minimal and formalistic formation of a partnership.

V. PROPOSED TAXATION OF CORPORATE TRANSFORMATIONS INTO PARTNERSHIPS

To recapitulate the preceding discussion, the two modes of taxing businesses either are “tax” or “no tax.” Business profits are taxed, whether directly to the business and then to its owners, or directly to the owners. On the other hand, mid-stream transformations tend not to be taxed. Notwithstanding the gain or loss realized by a party to the transformation, Congress determined that transformations were not the appropriate time for taxing such gain or loss. But an exception to the rule that transformations should not be taxed is for the conversion of corporations, either into partnerships or proprietorships. The transformation of a corporation into a partnership, and a proposed legislative remedy to the problem, are discussed in this section of the article. The thesis of this article is that a corporation’s conversion into a partnership or an LLC should not be taxed because it is more like the other nontaxable transformations than a taxable distribution of the business’ profits. The Code should be amended to provide that gain or loss realized by a corporation or its shareholders, as it converts into a partnership, should not be recognized.

196. See supra text following note 133.
197. See supra note 26.
A. Introduction

As noted, the Code strongly promotes the policy of not taxing business transformations, such as incorporation of a business or creation of a partnership, or the merger of one corporation into another. The most glaring exception occurs as a corporation is converted into a partnership. Quite possibly, Congress simply did not foresee the benefits—seventy or at least forty years later—of such a conversion when it more actively drafted statutes granting nonrecognition to transformations in the early 1920s and in 1954. Such a benefit did not crystallize until the recent advent of LLCs.

The remainder of this article discusses how corporations are taxed when they are converted into partnerships, some proposals for how they should be taxed, and sets forth a recommendation for its own scheme for taxing such conversions.

1. Present Taxation of Corporation-to-Partnership Conversions

A corporation's conversion into a partnership is a recognition event. Simply put, no nonrecognition statute, such as Sections 351 or 368, applies to the conversion. Gain or loss may be realized by the corporation in a conversion as it relinquishes its assets to the partnership and ceases to exist. Similarly, the owner ceases being a shareholder and becomes a partner. These dispositions of assets and stock necessarily entail the "disposition" of property which is, of course, a realization event under Section 1001(a) and which, in turn, is ordinarily a recognition event under Section 1001(c) as well.

If the conversion is not a nonrecognition transaction, how is it treated? It might be argued that because some business continues to exist, its profits should not be taxed other than as they would normally have been taxed, given the form of the business. But current law likens this to the liquidation of a corporation and the organization of a partnership. In other words, the Code recognizes business terminations and business creations and has statutory schemes for coping with these events. In contrast, it does not recognize some diffuse, theoretical continuation of business.

Thus, when a corporation converts into a partnership (or, more specifically, an LLC), the appropriate mode for taxing the transaction is to treat the corporation as if it has liquidated and that the shareholders have reconstituted their business association as a partnership.

198. Again, transformations of corporations into proprietorships are taxed, but a discussion of the negation of taxation of that transformation is beyond the scope of this article. See supra text following note 13. Furthermore, a second level of tax was imposed on liquidations in 1986. See supra Section III.B.2.

199. See supra note 10.

200. See generally Jill E. Darrow, Limited Liability Companies and S Corporations: Deciding Which Is Optimal and Whether to Convert to LLC Status, 48 Tax Law. 1, 31-35 (1994) (discusses tax consequences of conversion); Richard M. Lipton, Choice of Entity: How to Choose, How to
Two taxable events may occur when a C corporation liquidates. First, the corporation is taxed itself as it either sells property in liquidation or as it distributes property to its shareholders in liquidation. Second, the shareholders are taxed on distributions made by a liquidating corporation. Gain or loss from such a distribution is inevitably treated as capital gain or loss under Section 331, which treats the distribution as "full payment in exchange for the stock." Even if the liquidated corporation is an S corporation, these two taxes are incurred. While the corporation itself is not taxed on its gain as it sells its property in liquidation or under Section 336 as it distributes property in liquidation, the income so generated is taxed to its shareholders. Furthermore, they are taxed on capital gain under Section 331 as they receive distributions in liquidation.

Liquidations attendant upon the conversion of a corporation into an LLC may occur in a variety of ways under federal income tax law. Private rulings that preceded promulgation of the Section 7701 regulations in 1997, for example, tended to follow one of two patterns. First, a corporation's shareholders could form an LLC. Then, the corporation transfers its assets to the LLC in exchange for interests in the LLC, and the corporation can then distribute the interests in the LLC to its shareholders as it liquidates. Second, the shareholders could form an LLC and then merge the corporation into the LLC, which necessitates the liquidation of the corporation. Both methods have been used, although the merger and subsequent liquidation seems to be more common.

A third possibility was set forth in regulations proposed under Section 7701 later in 1997. If an election is made under the 1997 regulations, these proposed regulations prescribe the treatment of the conversion. Should an entity, eligible to elect under the regulations, voluntarily convert from taxation as an association taxable as a corporation into taxation as a partnership, the association is deemed to occur through the corporation's distribution of its assets and liabilities to its shareholders, followed by the shareholders' immediate contribution


201. See supra Section III.B.2.

202. I.R.C. § 331(a) (1997) (emphasis added). The exchange status therefore endows the distribution with capital gain or loss under I.R.C. section 1222 assuming, as is likely, that the shareholder owned her stock as a capital asset. See supra note 42.

203. See supra note 61.

204. For an example of the asset transfer and liquidation, see Priv. Ltr. Rul. 9701032 (Jan. 3, 1997) (subsidiary liquidated and assets then transferred to LLC). For examples of the merger and liquidation, see Priv. Ltr. Rul. 9701029 (Jan. 3, 1997) (merger of corporation into LLC followed by distribution of corporation's interests in LLC to corporation's shareholders); 9543017 (Oct. 27, 1995) (same); 9409016 (Mar. 4, 1994) (same); 9409014 (Nov. 29, 1993) (same); 9404021 (Jan. 28, 1994) (same). Private Letter Ruling 9543017 is noteworthy because the merged corporation was an S corporation.

of these assets and liabilities to the newly-formed partnership. The form of the liquidation should not affect the taxation of the liquidation. For example, in either case, the liquidation and its consequent taxation are taken into account. For example, if the corporation and the LLC respectively exchange their assets for interests, and the corporation distributes these LLC interests to the shareholders as it liquidates, then the liquidation is taxable to the shareholders and the liquidating corporation. An exception exists for a shareholder that is a corporation because nonrecognition is available under Section 332 to a corporate shareholder that liquidates a controlled subsidiary. In such a case, the nonrecognition available under Section 337 to a liquidating corporation that distributes its assets to its controlling shareholder also would shield the liquidating subsidiary from tax. Regardless of whether Sections 332 and 337 do or do not apply, the contributions made by the transferors of property to the LLC or the LLC’s distribution of its interests to these transferors would not be taxable under Section 721.

Alternatively, a merger of the corporation into the LLC, followed by the corporation’s liquidation, leads to nonrecognition of gain by the corporation and by the LLC into which it merges under Section 721. Distributions made by the corporation as it liquidates are taxable. Again, Sections 332 and 337 protect the liquidating corporation and its shareholder from recognizing gain if the latter controls the former. Thus, if a corporation converts into a partnership, both it and its shareholders are taxed, absent the special circumstances of a corporation’s liquidation by its corporate parent.

What devices exist to enable a corporation and its shareholders to avoid taxation? Doing nothing—i.e., not becoming an LLC—avoids taxation but precludes the corporation from being taxed as a partnership. Under current tax law, the best means for avoiding taxation and using LLCs is to use a common tax device that “freezes” events. For example, a parent may freeze the value of her property so that when she dies the value of property that has increased since the time of the “freeze” inures to her children’s benefit. She might do this by transferring the growth in her business—e.g., common stock in a corporation—to her children and retaining the interest less likely to appreciate—e.g., the preferred stock. Her estate tax is diminished because the size of her estate has been frozen.

In a somewhat different twist, a corporation may “freeze” the value of its property by contributing an asset to a partnership in exchange for a preferred

207. See supra note 67.
208. This type of situation is noted in the first sentence of supra note 204. Nonrecognition was available in this ruling because one corporation owned all the stock of the liquidating corporation.
209. This type of situation is noted in the second sentence of supra note 204. Of the examples set forth in that sentence, Private Letter Rulings 9409016, 9409014, and 9404021 involved Sections 332 and 337 nonrecognition.
interest in the partnership. Other partners—most probably the corporation's shareholders—contribute other property, such as cash, to the partnership in exchange for less senior partnership interests.\textsuperscript{211} The consequence of the formation of the partnership in this manner is to fix the corporation's investment at a relatively certain amount, and to permit the less senior interests in the partnership to appreciate. Furthermore, the shareholders' interests in the corporation have been diverted to the partnership, so that if and when the partnership assets are sold and the partnership liquidates, the partners receive capital gain, taxed at lower rates, as opposed to the double tax imposed on the transaction if the corporation had sold its assets and then been liquidated—once at the corporate level and again at the shareholder level.

The freeze has two effects. First, it diverts income to the corporation's owners—the other partners—through a pass-through entity, the partnership—and therefore diminishes the impact of the double tax on C corporations. Furthermore, the freeze ideally prevents further appreciation to the value of assets locked in the corporation. Avoidance of double taxation is likely to make a freeze more attractive to shareholders of a C than an S corporation. Nevertheless, the second effect may be significant enough or other reasons may exist to compel an S corporation to engage in a freeze.

Thus, current law permits a corporation to transform into a partnership, but taxes the conversion. Alternatively, a corporation may transfer assets into a partnership, but this route is more circuitous and not very efficient, especially when measured against the straightforward nonrecognition sanctioned by statute in other types of transformations. Why should conversions of corporations into partnerships—or, more specifically, conversions of S corporations into LLCs—be distinguished from other conversions because they are taxed? And, if there is no good reason, why not change the statutes governing the taxation of these conversions so that they no longer are taxed?

2. Some Proposals for Taxing Corporation-to-Partnership Conversions

Literature surrounding corporation-to-partnership conversions seems to dwell on the current taxation of the event more than how to remedy this taxation. But at least three proposals have been made to change the taxation of converting corporations into partnerships.\textsuperscript{212} All flow from the increased popularity of

\textsuperscript{211} See generally Lipton, supra note 200, at 318-19.

\textsuperscript{212} See also Treasury/IRS 1997 Business Plan, 74 Tax Notes 1230 (1997) (Internal Revenue Service plans to provide administrative guidance by end of 1997 on "elective conversion of an entity from partnership status to corporate status and vice versa"). Professor Hammill also briefly speculates on "what if" S corporations were taxed as partnerships. Hamill, supra note 13, at 409-10. Such speculation does not rise to the level of a proposal and, even if it did, still requires implementation. The statutory formality attached to many transactions, especially transformations, but the Code leads to this author's desire to urge enactment of statutory nonrecognition on corporation to partnership transformations, not merely S corporations converted into partnerships.
LLCs and the check-the-box approach to entity characterization fostered by the Internal Revenue Service's issuance of Notice 95-14. The Corporate Tax Committee of the Tax Section of the State Bar of California made the more comprehensive suggestion about taxing corporations that convert into partnerships. Leslie Samuels, then-Assistant Secretary for Tax Policy in the Treasury Department, made a brief statement as well, as did the Treasury Department. The Tax Section's proposal is addressed first.

a. Proposal of the Corporate Tax Committee of the Tax Section of the State Bar of California

Shortly after Notice 95-14 was issued, the Corporate Tax Committee of the Tax Section of the State Bar of California proposed that corporations be permitted to convert into partnerships without incurring a substantial tax burden. The committee grounded the proposal squarely in the increasing popularity of LLCs and this popularity's effect on choices of entity being made by entrepreneurs. As the committee turned from the likelihood to the taxation of these conversions, it questioned the propriety of taxing such conversions.

The committee perceived a lack of horizontal equity if newly-organized entities could effortlessly check the box to determine their form of taxation, most probably as LLCs taxable as partnerships, while preexisting entities—already-operating S and C corporations—were compelled to continue to be taxed as S or C corporations. These organizations could escape their present mode of taxation only by incurring the taxes imposed upon the liquidation of a corporation. This inequity and the increasing obsolescence of S corporations led the committee to make two proposals. In both cases, the committee argued only for a "one-time window." First, S corporations should be permitted to convert into an LLC or a partnership "if requirements similar to those imposed on" a Type F reorganization are met, including conditions such as continuity of shareholder interest, continuity of business enterprise, and the existence of a business purpose. Second, C corporations should be permitted to convert into an LLC or a partnership at less cost than Sections 331 and 336 ordinarily impose upon the liquidation of a C corporation. Instead, the committee proposed that (i) a corporation be permitted to pay tax on the corporate level gain over five years and the shareholders be...
permitted to avoid tax entirely, if requirements similar to a Type F reorganization were met; or (ii) a corporation should be taxed on the conversion on a deferred basis, along lines similar to the Section 1374 tax imposed on an S corporation’s built-in gains.217

By way of explanation, it should be noted that the committee was relying on concepts used elsewhere in business tax. Under Section 368(a)(1)(F), a Type F reorganization occurs when a corporation undergoes “a mere change in identity, form, or place of organization.” For example, a New York corporation’s reincorporation in Delaware is treated as a Type F reorganization.218 The preconditions the committee would attach to deferring gain on the conversion of a corporation into a partnership—continuity of shareholder interest and business enterprise as well as business purpose—are not necessarily more rigorous for Type F reorganizations than they are for other types of reorganizations.219 Section 1374 taxes an S corporation on its “built-in gain.” Even as corporations were compelled to recognize gain or loss whether they distributed or sold property in liquidation beginning in 1987, so too did Congress fear that gain at the corporate level might remain untaxed if the corporation at issue were an S corporation. Thus, Section 1374 was enacted in 1986 to tax these built-in gains.

The committee limited the conversion of S corporations into partnerships to “a one-time window” in order to avoid having “a significant revenue impact.”220 The committee was concerned that without the ability to avoid tax, owners of S corporations would refuse to convert into LLCs, despite their probable willingness to do so if they were starting fresh. Nor would they be required to enter into the “gamesmanship” of contributing property to a newly-formed LLC they would form with their shareholders.221 Similarly, the committee believed that its proposal for taxing C corporations as they converted into LLCs would be “a revenue raiser (or, at worst, [be] revenue neutral).”222 Ideally, a toll charge would be ascertained that could raise revenue, yet still entice businesses to shed their C corporation status and become LLCs.223

b. Statement of Leslie Samuels, Assistant Secretary for Tax Policy, Treasury Department

Shortly after Notice 95-14 was issued, Leslie Samuels, Assistant Secretary for Tax Policy in the Treasury Department, suggested that S corporations be

217. See id. Section IV.
218. See Rev. Rul. 57-276, 1957-1 C.B. 126 (reincorporation in another state is a Type F reorganization).
219. See generally Bittker & Eustice, supra note 46, at Ch. 12 (discusses reorganizations).
220. See id.; supra note 214, Section IV.B.
221. See id.; supra note 211 (discusses freezes).
222. See Comments, supra note 214, Section IV.C.3.
223. See id.
permitted to convert into LLCs "at least for a limited period of time" without paying tax. He hoped that such a provision would be included in legislation regarding S corporations. While legislation regarding S corporations was enacted soon thereafter, it did not address nonrecognition for converting S corporations into LLCs.  

c. Treasury Department Tax Simplification Proposals

Finally, the Treasury Department issued a report in April 1997 to simplify the federal tax laws. One—of several—proposals was aimed at S corporation conversions into partnerships. The Treasury Department proposed permitting an S corporation to "elect on a tax-free basis to be treated as a partnership" for tax purposes. The S corporation would be required to have no old C corporation earnings and profits and to recognize built-in gain at conversion. This proposal would simply let S corporations retain their state-law corporation form instead of converting into partnerships, in order to save the fees associated with a change of form.

B. Policies for Taxing Conversions of Corporations into Partnerships

Corporations that convert into partnerships—or, more specifically, C or S corporations that convert into LLCs—are usually taxed under current law. Tax is imposed because the conversion is treated as a liquidation, and corporate liquidations are ordinarily taxed, both to the corporation as it liquidates (either as it sells property in liquidation or makes distributions in liquidation) and to its shareholders as they receive distributions in liquidation. Tax may be avoided in the limited circumstance of a conversion somehow attached to a liquidation into a corporate parent. Tax also may be avoided if the corporation is simply continued, and it and its shareholders form a partnership. Neither scheme is accomplished easily. A parent-subsidiary group may not exist, or a corporation and its shareholders may not be able to join together easily in order to form a partnership. Thus, no simple method presently exists that permits a corporation or its shareholders to convert the corporation into a partnership without incurring tax.
Three proposals have been made for converting corporations into partnerships on a less cumbersome basis. Two of the proposals suggest that conversions be permitted on a tax-free basis one time only. A reason for the one-time conversion is offered only in one proposal, and that reason is to not diminish tax revenues, while simultaneously permitting conversions to occur as freely as possible.\textsuperscript{228}

Why permit a tax-free conversion to occur at all? And, if it is to be permitted, who should mandate it and what should be the contours of the conversion; for example, should such a conversion be permitted to occur once or repeatedly?

Congress is the appropriate institution to initiate change in this area. Other transformations are permitted, but always under the aegis of statutes, such as Sections 351, 368 and 721. Of course, other authority surrounds these statutes. Some of this authority is drawn by other statutes, by courts, or by the Internal Revenue Service.\textsuperscript{229} But courts have not established rules independently permitting other business transformations to occur without the imposition of tax. Nor should courts be expected to do so when dealing with the transformation of a corporation into a partnership, and the Service should not draw rules in this area. The tightly-drawn scheme of nonrecognition statutes suggests that the Service could not extend nonrecognition to corporation-to-partnership conversions.\textsuperscript{230}

The proposal of the Corporate Tax Committee of the Tax Section of the State Bar of California for permitting corporation-partnership conversions essentially argues that business should be permitted to flow more freely; LLCs have increasingly gained popularity, a status formerly occupied by S corporations. This is implicit in the Treasury Department’s proposal as well. Without some means of permitting C or S corporations to convert into LLCs, businesses will become contorted because they cannot convert without incurring tax. Thus, the committee would permit corporations, especially S corporations, to convert into partnerships, especially LLCs, without causing the participants to pay tax, or at least not currently. It might impose some toll charge, and certainly would not let a conversion occur a second time without triggering tax.\textsuperscript{231}

Over seventy years ago, Congress enacted laws permitting other transformations to occur without incurring tax. Its reasons included diminishing uncertainty, preventing taxpayers from taking “colorable losses . . . in fictitious exchanges,” and not interfering with “necessary business readjustments.”\textsuperscript{232} To some

\textsuperscript{228} See supra notes 220-223.
\textsuperscript{229} See supra Section IV.C, D.
\textsuperscript{231} See supra Section VA.2.a. See also ALI Memorandum No. 2, supra note 46, at 21-22 (notes possible size of transition costs, should a uniform method of taxing businesses be adopted).
\textsuperscript{232} See supra note 152.
extent, these rationales are compelling reasons for extending nonrecognition of gain or loss to transformations of corporations into partnerships.

The predictive aspect of tax law—e.g., "If I engage in action x, I can expect to pay $y tax."—is an essential part of tax practice and business planning. Taxation of corporation-to-partnership conversions already has a predictive element; it is just an unattractive one. If other transformations enjoyed nonrecognition and were permitted in order to diminish uncertainty, it follows that uncertainty would be diminished just as much if this type of conversion were permitted without triggering tax.

The risk that an entrepreneur would transfer depreciated property to a controlled entity in order to take a loss into account and deduct it is as great if that entity is a corporation instead of a partnership. If she can trigger recognition of that loss when transferring it to a corporation (e.g., by selling property to a corporation and thus avoiding Section 351), she can trigger recognition of that loss when transferring it to a partnership as well, again by selling the property and thus avoiding Section 721. Thus, the nonrecognition of losses that prompted enactment of Section 351 equally justifies enactment of a statute that would compel nonrecognition of losses upon the transfer of property as a corporation transforms into a partnership.

Finally, the growing urgency of S corporation conversions into partnerships—one strong enough to cause the Internal Revenue Service to unilaterally promulgate check-the-box regulations—underscores the need to promote changes in the taxation of conversions as well.

Sound reasons, such as limited liability combined with the flexible pass-through of income and deductions to owners, induce corporations to convert into LLCs. Thus, horizontal equity—the concept that like taxpayers be treated alike—dictates that corporations seeking to convert into partnerships be treated the same as other businesses seeking to transform themselves, by granting them the same nonrecognition granted to these other businesses. Horizontal equity also dictates that this nonrecognition be granted on an absolute and repeated basis, and not just once, as the two proposals in the area have suggested. While a corporation that has converted into an LLC cannot convert directly into an LLC again, it might convert back into a corporation and then seek LLC status a second time. Transformations such as corporate reorganizations and partner-

233. See generally Richard L. Doemberg & Fred S. McChesney, On the Accelerating Rate and Decreasing Durability of Tax Reform, 71 Minn. L. Rev. 913 (1987) (examines types of bargains struck when tax legislation is enacted); Bittker & Lokken, supra note 40, ¶ 1.2.6 (discusses retroactivity of tax laws).
235. See generally McKee et al, supra note 46, ¶ 4.06[2].
236. See supra note 109.
237. See supra text accompanying note 105.
238. See generally Bittker & Lokken, supra note 40, ¶ 3.1.4.
ship-to-corporation conversions are not limited in number; why should corporation-to-partnership conversions be so limited?

If Congress regulates corporation-to-partnership conversions, it could do so by somehow taxing the accumulated profits of the business during conversion or by granting nonrecognition to the conversion. Taxing profits is a recurring theme in the Code and so taxing profits during the course of this type of conversion is attractive. But taxing profits does not occur in the abstract. Congress has already carefully honed schemes for taxation, set forth in subchapters C, K, and S of the Code, and a corporation's profits are taxed as it makes a nonliquidating distribution, not as it liquidates or otherwise continues its business in another form.\(^{239}\) Furthermore, taxing profits is not inevitable. Congress could have, but chose not to, tax profits in corporate liquidations, even though these profits would otherwise escape taxation because the corporation would no longer engage in business. That Congress permitted shareholders to escape taxation on their profits as profits (i.e., as dividends) when their corporation liquidates suggests that it should take no less harsh a course in corporation-to-partnership conversions.

Instead, granting nonrecognition seems to be the more natural course for Congress to follow. Business transformations usually signify a change in, but also a continuation of, a business; e.g., as a corporation or partnership is formed or as a corporation engages in a reorganization. A liquidation also might lead to a continuation of a business because, for example, a shareholder may simply decide that she will run her business through a proprietorship instead of a corporation, but a liquidation also may reveal a cessation of business, alone among all other types of transformations.\(^{240}\) Converting a corporation into a partnership contrasts with a liquidation because the business will continue. Thus, nonrecognition is the appropriate model for taxing corporation-to-partnership conversions.\(^{241}\)

If gain and loss realized in corporation-to-partnership transformations should not be recognized, what form should the statute permitting nonrecognition take? That topic is addressed in the next section of this article.

C. Legislative Scheme for Converting Corporations into Partnerships Without Recognition of Gain or Loss

Simple statutes could be designed to enable a corporation to convert into a partnership without recognizing gain or loss. The broad scheme—linking nonrecognition with a basis designed to compel later recognition of previously

\(^{239}\) See supra Section III.B.

\(^{240}\) Corporations or partnerships may cease to do business, but devices exist for taxing them if they should terminate. See, e.g., what activities lead to a termination of a partnership under I.R.C. section 708(b)(1)(A), discussed in McKee et al., supra note 46, ¶ 12.02, and of a corporation under §§ 331 and 332, discussed in Binkler & Eustice, supra note 46, ¶ 10.02.

\(^{241}\) Implicit in calling for nonrecognition is rejection of the California bar committee’s desire to use conversions to raise revenue. While using taxes to raise revenue is a laudable goal, equity and fostering business transformations dictate nonrecognition.
untaxed gain or loss—is established firmly enough elsewhere in the Code to be used here as well. Beyond that, a variety of choices are presented. For example, transfers to corporations entail some type of control by the transferor after the transformation, whether Section 351 or the reorganization provisions surrounding Section 368 apply. Transfers to partnerships do not require that the transferor control the partnership after the exchange. Which is the more apt analogy as a corporation is transformed into a partnership? How should debt be dealt with? Corporate transformations handle debt in one mode and partnerships in another. And what type of “common law” should surround the transformation once nonrecognition for the transaction has been enacted into law?

I. Nonrecognition and Attendant Basis

While nonrecognition must be provided to a corporation as it converts into a partnership, the problem for a corporation converting into a partnership lies less in the conversion into a partnership than it does in the termination of a corporation. In other words, the present structure of the Code accommodates the conversion into a partnership. Section 721 and the attendant basis sections that compel later recognition of an amount theoretically equal to currently unrecognized gain or loss—Sections 722 and 723—would account for creation of a partnership by former shareholders of a corporation, just as they presently account for creation of a partnership from any other route.

On the other hand, the termination of a corporation is a taxable event. A statute must be enacted that endows the termination of a corporation with nonrecognition. In a sense, this battle was lost—rightly—when the statutory traces of General Utilities were repealed in 1986 as corporate distributions to shareholders of appreciated property became recognition events, whether or not made during the course of a liquidation. But conversions cannot be effected until some exception is carved out for corporations converting into partnerships. At the very least then, distributions of corporate property must be a nonrecognition event if the distributions are associated with the corporation’s transformation into a partnership. Therefore, a statute must be enacted that grants nonrecognition to a corporation as it ceases to exist pursuant to becoming a partnership. Perhaps this nonrecognition event could be defined as those modes by which a corporation converts into a partnership under state law; e.g., if the partnership is an LLC, by transferring its assets to an LLC or by merging into an LLC.

242. See supra Section IV.C. In addition to the broad scheme set forth below, some other issues presented by the conversion of corporations into LLCs are noted at McKee et al., supra note 46, ¶ 2.02[5]. See also Monte A. Jackel & Glenn E. Dance, Elective Entity Conversions Under Proposed Check-the-Box Regs, 78 Tax Notes 595 (1998) (same).

243. See supra Section IV.C, D.

244. For General Utilities, see supra Section III.B.2. For state law means of a corporation converting into an LLC, see supra note 204.
Should absolute proportionality of interests in the corporation and the partnership be an element of the transformation to which nonrecognition would be granted? If three equal shareholders become three equal partners, nonrecognition should not be disputed. But what if one of the shareholders became less than a one-third partner (and one or both of the others, perhaps, became more than a one-third partner), or what if one of the shareholders, while continuing to "own" something valued at one-third of the partnership's value, acquires differing interests in the capital and the profits of the partnership (e.g., one-fourth of the capital interests and two-fifths of the profits interest)?

The appropriate answer to the proportionality question is no; proportionality should not be required, and the rationale for this answer lies in law already surrounding the formation of partnerships. Current law offers great flexibility to the organization of partnerships. Any exchange of property for a capital interest in a partnership is a nonrecognition event, regardless of whether the transferor of property owns one or fifty percent of the partnership's capital interests thereafter.245 Exchanges of services for partnership interests may be taxable as well, depending upon whether the laboring partner receives a capital interest (which is taxed) or a profits interest in the partnership (in which case tax may ordinarily be avoided).246

What if a shareholder cashes out somewhat as she participates in the conversion of her corporation into a partnership? For example, she might exchange her stock in a corporation for consideration, eighty percent of which is a capital interest in a partnership and twenty percent of which is cash, debt, or other property, exclusive of a partnership interest. The models by which to measure her cashing-out include: (1) the liquidation provisions, which would tax her on all consideration received, less her basis in the stock, and are therefore unacceptable; (2) Section 351, regarding incorporation; and (3) the reorganization provisions surrounding Section 368. Section 351(b) would simply tax this shareholder on the amount of cash or other boot she has received.247 In contrast, the reorganization provisions, specifically Sections 354 and 356, would tax her to the extent she has cashed out, as capital gain or as ordinary income, if the distribution had the effect of a dividend. Because the reorganization provisions deal with the transformation of a business from the corporate form, if only into another corporate form, while Section 351 addresses entry into the corporate form of doing business, the reorganization model seems to be the most

245. See supra note 178.
246. See supra note 188. See also McKee et al., supra note 46, ¶ 4.01[4] (person who contributes property to partnership in exchange for partnership interest and boot recognizes gain in the part-contribution, part-sale).
247. See supra note 130. Gain is recognized under I.R.C. section 351(b) by reference to the boot attributed to each asset transferred pursuant to the section. See Rev. Rul. 68-55, 1968-1 C.B. 140. Thus, if the asset transferred was a capital asset, the transferor recognizes capital gain; if it was not, then she has ordinary income.
appropriate model for taxing a shareholder who cashes out as her corporation converts into a partnership.  

The only other transformation of a C corporation into a pass-through entity that currently does not trigger recognition of gain or loss is the transformation of a C into an S corporation. As Congress repealed the statutory traces of General Utilities in 1986, it enacted and imposed the Section 1374 tax on an S corporation's built-in gains out of concern that C corporations might convert into S corporations in order to avoid the corporate level tax now imposed on a corporation's distributions of appreciated property. To what extent should Section 1374 or a similar provision's reach be extended to conversions of corporations into partnerships?

One possibility, of course, is that Section 1374 is yet another example of Congressional overkill, and is far more complex a solution than the problem deserves. But assuming that Congress does not simplify or eliminate Section 1374 in the near future, should this law somehow be extended to cover corporate conversions into partnerships? At this point, a greater distinction can be drawn between conversions of C and S corporations into partnerships. A stronger case can be made for applying a Section 1374-type statute to the conversions of C than S corporations because avoidance of corporate level tax occurs whether the conversion is into an S corporation or into a partnership. In both cases, the pass-through entity is not taxed at all, much less on its distributions of appreciated property. In both cases, a pass-through entity has received appreciated property from a C corporation. Therefore, the partnership should be taxed when it disposes of its property with built-in gain just as much as it would if it were an S corporation.

In contrast, an S corporation that converted into a partnership should not compel application of a Section 1374-type statute to the S corporation's built-in gains. Corporate-level tax never would have been imposed on the S corporation; therefore, no purpose was served by imposing Section 1374 or a tax like Section 1374 on the partnership and its built-in gains.

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248. See Clark v. Commissioner, 489 U.S. 726, 109 S. Ct. 1455 (1989) (IRC § 302(b) redemption test used to determine whether distribution of boot had effect of a distribution of a dividend under § 356(a)(2)).

Implicit in this article's assumption of the propriety of a corporate, as opposed to a partnership, transformation model is rejection of the anti-abuse statutes imposed on partnerships. A review of these statutes by the ALI is mentioned, supra note 124.

249. See supra note 71.

250. Cf. Bittker & Lokken, supra note 40, ¶ 95.6.6 (simple solution to corporate level tax rejected).

251. A partner is taxed on appreciated property distributed to her only when she sells it; she can be taxed on a distribution only if it is in excess of her basis in the partnership and only if it is a distribution of cash. See supra notes 80-82.

252. See also Treasury Department Proposal, supra note 225, which would tax built-in gains currently as an S corporation converts into a partnership. A somewhat more difficult question is presented by the conversion of an S corporation that formerly was a C corporation into a partnership.
Some argument can be made against imposing a Section 1374-type tax on a partnership that formerly was a corporation. This Section 1374-type tax contradicts the scheme for taxing partnerships that has been carefully thought through and become Subchapter K of the Code. Furthermore, the risk that a partner would somehow abuse the partnership form of doing business by selling appreciated property distributed to her by the partnership exists even if the property did not come to her from an entity formerly taxed as an S corporation. Overall, however, a better case can be made for imposing a Section 1374-type tax, especially on partnerships that once were C corporations. Therefore, such a tax should become part of the nonrecognition available to corporations that convert into partnerships.

The Corporate Tax Committee of the Tax Section of the State Bar of California has suggested that corporation-to-LLC conversions be permitted, in part, "if requirements similar to those imposed on" a Type F reorganization are met. In some ways, this suggestion is laudable. For example, if all a corporation does in a Type F reorganization is to reincorporate elsewhere (e.g., in another state), there is likely to be a strong or even a complete identity among the shareholders of the old and new corporations. It might be deduced that the committee was trying to establish a similar identity among the shareholders of a corporation and the members of the LLC that it became. As the preceding discussion reveals, however, a more sophisticated approach can be taken to corporation-to-partnership transformations than merely adopting principles similar to Type F reorganizations. In other words, the F reorganization is too broad a tool to wield against corporation-to-partnership conversions.

2. Taxing the Former Corporation's Profits

How should the profits of a corporation be taxed as it converts into a partnership? This question actually breaks down into two questions because there are two types of corporations: C and S corporations.

If a C corporation converts into a partnership, the possibility exists that it has not yet distributed all of its profits. Only those profits distributed from the corporation's "earnings and profits" are taxed to the shareholders. A C corporation's shareholders should not be permitted to avoid the tax imposed on these profits just because their business has changed into another form. For example, if it had become an S corporation, distributions in excess of the corporation's earnings as an S corporation (i.e., its accumulated adjustments

Presumably, a device similar to I.R.C. section 1374(c)(1), which treats "an S corporation any predecessor corporation . . . as I corporation" could be used to treat the partnership and its predecessor corporations as one, thereby insuring that the partnership would be taxed on its built-in gain.

253. See supra note 217.
254. See supra note 218.
255. See supra notes 48-51.
account) would reach back into the earnings and profits pool in order to tax the shareholders on the corporation's earnings and profits generated by its former life as a C corporation. It would be easy enough to apply a similar model to C corporation shareholders who convert their stock into interests in a partnership.

Other alternatives, such as taxing these people with their newly-acquired partnership interests on these profits immediately, are possible, but because Congress has chosen not to tax S corporation shareholders immediately on the corporation's former C corporation earnings and profits, it would not be fair to tax partners more quickly. Indeed, the appropriate partnership tax model would be to lower a partner's basis in property distributed to her by the partnership, so that if and when the partnership distributes an amount of money to her that exceeds her basis in the partnership, she is taxed. Using a similar model here would be more appropriate than taxing her immediately. In any case, some type of deferred taxation, such as that permitted by an accumulated adjustments account for a partnership or by lowering a partner's basis in her partnership interest, would be more appropriate than taxing her immediately.

If an S corporation converted into a partnership, there would be less need for taxing the partners on the S corporation's profits. The former shareholders should have been taxed as the S corporation earned its profits; after all, the S corporation is a pass-through entity. If it already were taxed, then no profits should remain to be taxed as the S corporation converts into a partnership. In this case, there should be no problem.

3. The Role of Debt

Debt has an impact upon transformations, regardless of whether it is recourse or nonrecourse debt. For example, in corporate organizations, Section 357(a) insures that the transferor's shedding of liabilities does not compel her recognition of gain or loss by refusing to treat the discharged debt as boot. Discharge of indebtedness, however, ordinarily is income to a taxpayer such that the transferor's release from liabilities should have some effect on her and that effect occurs under Section 358(d), which compels her to have a lower basis in the stock she has received without recognizing gain such that her subsequent sale of stock should lead to more gain or less loss at some later point in time.

In reorganizations, discharge of debt can occur in a variety of manners. In reorganizations involving the disposition of the target corporation's assets, Section 357 is again invoked in order to permit the corporation that discharges
its debts to avoid recognizing any gain or loss. Similarly, Section 358(d) would compel the target corporation to have a lower basis in the transferor's stock and property it has acquired, although the stock and property would ordinarily be distributed immediately by the target.\footnote{261} A shareholder also might dispose of debt—specifically "securities" (which is generally regarded to be long-term debt)\footnote{262}—in a reorganization; these securities would be debt of a corporation involved in the reorganization, the target corporation. Her disposition of these securities does not trigger her recognition of gain or loss unless the securities she disposes of exceed the amount of securities she receives in the reorganization from the acquiring corporation.\footnote{263}

Finally, when a partnership is organized, debt has one of several impacts. If a partner becomes burdened with debt—if, for example, she becomes responsible for twenty-five percent of the partnership's $1,000 recourse debt because she is a twenty-five percent partner in a general partnership—Section 752(a) treats this as her contribution of cash to the partnership, such that her basis in her partnership interest will increase by $250.\footnote{264} On the other hand, if she is relieved of debt during the course of a contribution to a partnership—if, for example, she no longer is responsible for $1,000 of recourse debt—then Section 752(b) treats her as receiving a distribution of cash from the partnership. Under Section 731(a), she would recognize gain only if the amount of this putative distribution of cash exceeded her basis in her partnership interest.\footnote{265} This distribution also would decrease her basis in her partnership interest under Section 733.\footnote{266}

Which is the best model for the treatment of debt for a corporation converting into a partnership? Clearly, as contributions are made to the partnership, Section 752 should be applied.\footnote{267} If the partnership is an LLC,
then the debt must be treated as nonrecourse debt because a member in an LLC is not liable for the entity's obligations.\textsuperscript{268}

The model is less clear for taxing a shareholder in the corporation actually transformed into the partnership. The treatment provided for in a Section 351 transaction, in which a transfer is made to a controlled corporation, is not quite apt because, again, it involves the formation (or continuation) of a corporation as opposed to its ultimate disappearance. The shareholder is not receiving debt in lieu of an interest in the corporation, which is the situation most analogous to her receiving debt of the partnership.

Instead, the reorganization provisions provide a stronger anchor from which to reason. Part of what prompts a shareholder to be taxed as she receives more corporate debt than she surrendered is her cashing-out. If she transfers stock worth $10,000 and takes back stock worth only $7,500, she has cashed out $2,500 regardless of whether she received debt or cash totaling $2,500. Thus, it would be more appropriate to tax a shareholder to the extent that she receives or is allocated debt of the partnership that is greater than the debt in the corporation which, indirectly, she surrendered.\textsuperscript{269}

\textbf{4. A Road Not Taken: Only Taxing a Business' Profits and Termination}

Extending nonrecognition to corporate conversions into partnerships (or proprietorships) is not inevitable. Another possibility—one this author rejects in closing the article—would be to tax businesses only as they earn profits or as they terminate. For example, a corporation's profits could be taxed to it and to its shareholders as the corporation's earnings and profits are distributed to them. A statute could be drafted so that no mid-life transformation is taxed, perhaps by granting nonrecognition to whatever gain or loss a party to such a transaction realizes. If necessary, a transaction that is not a distribution of profits and is not a liquidation might be described as a distribution, for example, from a corporate trade or business or a corporation's actively-conducted trade or business. After all, such terms are already defined by the Code and might be grafted onto this new scheme.\textsuperscript{270}

\textsuperscript{268} See supra text following note 39. In the example in the preceding note, A would be liable for the LLC's debts (if the partnership were an LLC), according to her share of the LLC's profits. In that example, the result would be the same regardless of whether the debt is recourse or not because A is a one-fourth partner in the partnership's profits and in its economic risk of loss. If A's interests in these items varied, however, then the nature of the debt could make a difference.

\textsuperscript{269} See I.R.C. §§ 162 and 355(a)(1)(C), (b) (1997).

\textsuperscript{270} It stands to reason that other provisions that deal with even more sophisticated questions, such as original issue discount, which arises under I.R.C. section 1273(a) when the stated redemption price of debt exceeds its issue price, could be imported into this area as well.
In some ways, such a scheme is intriguing. The law would recognize that which is already the case: profits are taxed, liquidations are taxed, and mid-life transformations, now extended to a business that leaves its corporate state of being to become another type of entity, are not taxed. The benefit of the proposal, set forth in part V.C. of this article, is that it more accurately describes current law. There might be a simplicity to accurately labeling non-taxing mid-life transformations as not taxing any transformation made by a trade or business or an actively-conducted trade or business. The cost, however, would be that more changes would be required to be made to the Code. In other words, granting nonrecognition to parties associated with corporations converting into partnerships (or proprietorships) is less intrusive. It would more fully close the circle of taxing business transformations.

VI. CONCLUSION

Different types of business entities serve different purposes. Persons engage in business in one of these forms for particular reasons, some of which are prompted by business considerations, and some of which are prompted by the effect of the federal income tax. Carefully-honed schemes have been constructed in the Code to tax these businesses. For example, a C corporation is taxed on its profits and so are its shareholders as those profits are distributed to them. A C corporation is not taxed, nor are parties associated with it, as it is organized or engages in a reorganization. It and its shareholders, however, are ordinarily taxed as it liquidates. Similarly, detailed rules govern the taxation of S corporations and partnerships.

Increased use of one type of entity, LLCs, seems likely, and it also seems likely that this increased use will be accompanied by a decreased use of S corporations. Currently, corporations are taxed as if they have liquidated when they convert into LLCs. Such a result leads to awkward devices to permit the attractive S corporation-to-LLC conversion. It would make more sense if these conversions—indeed, if all corporation-to-partnership conversions—were not taxed. Therefore, the Code should be amended in order to permit such conversions to occur without the corporation or its shareholders recognizing gain or loss. Were that done, the mechanisms for taxing businesses already in place could accommodate the change and the circle of taxing business transformations would be more fully closed.