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33rd Annual LLCs, LPs and Partnerships

July 11, 2024

Breaking Up is Hard to Do: S Corp, LLC and Partnership Divisions

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Introduction: Spin Offs or Split Ups

Modern Realities

- Business strategies trend toward decentralizing company assets.
  - Minimizing company assets to only operating assets.
  - Separating intellectual property & real estate.
  - Isolating company assets from business risks.
- Companies contain non-essential assets.

S Corps compared with C Corps

- Sub-S corporations differ from C Corporations.
  - No entity level tax.
  - Tax on S-Corp's income is at individual tax rates (37% for its ordinary income; 20% for capital gains.
  - No double taxation of earnings distributed to shareholders.
  - No double taxation when business is sold, with some exceptions.

S Corps compared to Partnerships or LLCs

- Sub-S are similar to partnership and LLCs – all 3 are pass-through entities for federal tax purposes.
- There are differences, some of which are:
  - S Corps have single class of stock with proportionate sharing of income, gains, losses, and distributions.
  - S Corps have arbitrary rules limiting number and identity of shareholders.
  - S Corp is a corporation.
  - Partnership and LLC liabilities affect owners' basis in their partnership or LLC interests.

S Corps are Corporations for Division Purposes

- Sub-S are corporations for many federal tax purposes, such as splitting up and reorganizations.
- Corp rules guard against avoiding double taxation.
- Must follow corporate division rules, which are complex.
- S Corps don't have to worry about earnings bailouts

Partnerships and LLCs

- Partnerships and LLCs taxed as partnerships follow a different division regime from S Corps.
- A partnership division takes place if
  - partnership splits-up into two resulting partnerships, and
  - both partnerships have at least two members from the divided partnership.
- The resulting partnership whose members owned more than 50% of the prior partnership is a continuing partnership.
- The partnership that continues whose members owned the largest percentage of the prior partnership is the surviving partnership (a/k/a "divided partnership").
- Only continuing partnerships are ensured a tax-free division.

Title search: "Breaking Up is Hard to Do": S Corp, LLC and Partnership Divisions

First appeared as part of the conference materials for the
33rd Annual LLCs, LPs and Partnerships session
"“Breaking Up is Hard to Do”: S Corp, LLC and Partnership Divisions"