

S corporations: A Cautionary Tale about Squaring the Circle

LLCs, LPs and Partnerships
Thursday July 14, 2023

1

Faculty

- Dan G. Baucum, Ferguson Braswell Fraser Kubasta PC - Plano, TX
- Robert R. Keatinge, Holland & Hart LLP, Denver

2

2

Choice of Entity

Interaction of Tax and Business Rules

- Partnership taxation is based on state-law business organization rules for allocation and distribution of economic results
- An S corporation is not a corporation taxed as a partnership
- If an LLC and its owners are subject to S corporation rules, the state-law economic architecture must be changed in the company agreement

3

3

Sub K v. Sub S Non-Compensatory Distinctions

Characteristic	Sub K	Sub S
Flexibility in economic sharing of non-compensatory results and distributions (IRC §§ 704 v 1366(a)(1))	Yes	No
Built-in gain on contributed property allocated to contributor (IRC §§ 704(c) v 1366(a)(1) & 1366(f)(2))	Yes	No
Default to Subchapter C rules (IRC §1371(a))	No	Yes
Concern with debt/equity rules (IRC §385, Treas. Reg. §§1.1361-1(I)(4) and (5))	No	Yes
Inadvertent conversion to C corporation (Treas. Reg. §301.7701-3 v IRC §1362)	No	Yes
Limitation on amount payable on dissociation (Treas. Reg. §1.1361-1(I)(5))	No	Yes
Restriction on number and eligibility of owners	No	Yes
Reporting of owner basis (Forms 1065 sched M v 7203)	Yes	Yes
Ordinary loss on sale of interest (IRC §§ 741 v 1244)	No	Yes

4

4

Sub K v. Sub S Compensatory Distinctions

Characteristic	Sub K	Sub S
Owners to be employees for tax purposes (Rev. Rul. 69-184)	No	Yes
Ability of individual owners to avoid Medicare HI tax or NIIT (except under IRC §1402(a)(13))	No	Yes
Requirement for reasonable compensation of service providing owners (<i>Radke</i> 895 F2d 1196 (7 th Cir 1990))	No	Yes
Treatment of unvested interests (IRC §83(b))	?	Yes
Compensatory options to acquire interests (Notice 2000-29 and 68 FR 2930 v IRC §83(b))	?	Yes
Ability to grant profits interests (Rev. Procs. 93-27 and 2004-43, IRC §1062)	Yes	No

5

5

DRE (individual) v. Sub S

Characteristic	DRE	Sub S
Flexibility in economic sharing of non-compensatory results	<u>N/A</u>	<u>N/A</u>
Ability for owners to be tax employees	No	Yes
Ability of individual owners to avoid Medicare HI tax or NIIT	<u>No</u>	Yes
Requirement for reasonable compensation of service providing owners	No	Yes
Default to Subchapter C rules	No	Yes
Concern with debt/equity rules	No	Yes
Inadvertent conversion to C corporation	No	Yes
Limitation on amount payable on dissociation	<u>N/A</u>	Yes
Restriction on eligibility of owners	No	Yes
Ordinary loss on sale of interest	No	Yes

6

6

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the [UT Law CLE eLibrary \(utcle.org/elibrary\)](http://utcle.org/elibrary)

Title search: S corporations: A Cautionary Tale about Squaring the Circle

Also available as part of the eCourse

[Answer Bar: LLCs and Partnerships Formation](#)

First appeared as part of the conference materials for the
31st Annual LLCs, LPs and Partnerships session

"S corporations: A Cautionary Tale about Squaring the Circle"