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

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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.

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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.

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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.

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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.

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