## THE PARTNER'S PERSPECTIVE by *Charles R. Levun, Esq.*

*Charles R. Levun, JD, CPA, is a Partner in the Chicago-area law firm of Levun, Goodman & Cohen, Adjunct Professor of Law at the IIT Chicago-Kent Graduate Tax Program, Consultant to the* **CCH** INCORPORATED's PARTNERSHIP TAX PLANNING and PRACTICE GUIDE *and Editor-in-Chief of the* JOURNAL OF PASSTHROUGH ENTITIES.

### *Lurking Code Sec. 704(c) Issues When Making Code Sec. 704(b) Allocations*

Over the last 20+ years, the Partner's Perspective has been filled not only with a discussion of current developments but also with structuring considerations for what appear on their face to be garden-variety transactions, but that may involve more issues than one might first surmise. This month's Partner's Perspective will fall into the latter category.

Several years ago (but after August 10, 1993, when the anti-churning rules of Code Sec. 197 would no longer be relevant) Elliott started several related business operations in various locations that have caught on; however, he currently needs additional capital to take his ventures to the next step. For liability protection purposes, separate corporations were formed for each of the business operations; however, for some inexplicable reason, each corporation is a C corporation.

Dana is the angel investor who has agreed to pay $3,000,000 to Elliott for a 50% interest in his business operations. In addition, she has agreed to infuse $7,000,000 of capital to expand the ventures, for which she will be entitled to a liquidation priority upon the occurrence of a liquidity event (e.g., a sale or refinancing of the business) together with a preferred return.

Assume, for simplicity purposes, that the corporations have no hard assets and their value is strictly attributable to goodwill and going concern value, and that Elliott has no basis for his stock in the corporations.

### *The S Corporation Considerations*

Of course, in Elliott's ideal world, he would like to sell 50% of his stock and recognize capital gain on the $3,000,000 to be paid to him by Dana. In the real world, this is unlikely to happen for several reasons.

First, Dana's $10,000,000 equity acquisition/capital infusion would become subject to both identified and unidentified liabilities of the corporations conducting the business operations. Representations and indemnities might be obtained; however, that only takes one so far.

Second, in all likelihood, Dana will desire flow-through taxation. This might be accomplished by means of an S election for each of the corporations [or a restructuring of the business to create an S corporation holding company with qualified S corporations subsidiaries ("QSubs") that each own one of the business operations]; however, as summarized below, S status creates numerous obstacles and so many shortcomings from Dana's perspective that she likely would reject that structure.

First of all, in order to be eligible to make an S election, there can be only one class of stock (other than voting rights differences). Consequently, something has to be done with Dana's preferred return and $7,000,000 liquidation priority, lest this requirement will be flunked. Code Sec. 1361(c)(5) contains a straight debt safe harbor, whereby straight debt will not be treated as a second class of stock. Among the other requirements of straight debt is that it (1) must be payable on demand or at a specified date and (2) the interest rate is not contingent on profits. Given the proposed structure of Dana's preferred return and liquidation priority, it is not possible to meet these requirements without changing the economic arrangement between Elliott and Dana.

And even if the transaction could be restructured to satisfy the straight debt safe harbor, Dana likely would have other objections to an S corporation structure. First, she would obtain no tax benefits for the $3,000,000 stock purchase, other than having $3,000,000 of stock basis. Second, the S corporations would be subject to the built-in gains tax of Code Sec. 1374, if there were a sale of intangible value of the business operations during the first ten years of S status, and Dana would bear 50% of any such built-in gain responsibility.

For example, assume the assets of the S corporations were worth $6,000,000 at the time of the S elections (based on a $3,000,000 purchase price of 50% of Elliott's stock) and had a zero tax basis (i.e., the sole assets being self-created intangible value). Further assume that the business operations existing at the time of Dana's stock purchase were sold shortly thereafter for $6,000,000, plus the $7,000,000 required to repay Dana's $7,000,000 "loan." The $6,000,000 gain on sale would be subject to a Code Sec. 1374 built-in gains tax of $2,100,000 ($6,000,000 @ 35%); Dana would be allocated income of $1,950,000 [50% multiplied by ($6,000,000 income less $2,100,000 built-in gains tax)], which would be taxed at 15% (because the sale of self-created intangible value produces capital gain).

Not only would Dana currently pay federal income tax of $292,500 (15% times $1,950,000), but if the S corporations thereafter liquidated, Dana's share of the cash from sale (after the repayment of her $7,000,000 "debt") only would be $1,950,000, resulting in a $1,050,000 economic loss ($3,000,000 purchase price less $1,950,000 liquidating distribution) and a $3,000,000 capital loss ($3,000,000 initial basis plus $1,950,000 gain recognition less $1,950,000 liquidating distribution). In other words, Dana will have inherited 50% of Elliott's double tax problem that emanated from his failure to form in flow-through format in the first instance. And if the liquidation of the S corporations took place in a year following the year in which the business operations were sold, Dana may be faced with $1,950,000 of recognized gain from the earlier year sale and a potentially unutilizable $3,000,000 capital loss.

For all the foregoing reasons, Dana likely will not be happy with the purchase of 50% of Elliott's stock, even if S elections were made. Instead, she will be searching for another structure that will put a smile on her face.

### *The Drop Down Structure and Making Code Sec. 704(c) Disappear*

A common structuring approach for Dana would be for her to insist that Elliott's corporations contribute their assets to newly formed LLCs (to avoid "cross-collateralization" among the business entities) and then contribute the LLCs to a "holding company/parent" LLC. Dana will then purchase, for an aggregate purchase price of $3,000,000, 50% of each corporation's membership interest in the parent LLC and the parent LLC would then make a Code Sec. 754 election. As a result, Dana would obtain a Code Sec. 743(b) basis adjustment which, based on the assumed facts, would be attributable to goodwill and going concern value and thereby would be amortizable over 15 years under Code Sec. 197. If the existing business operations were sold shortly after Dana's admission to the LLC, there would be $6,000,000 of gain that would be allocated equally between Elliott's corporations and Dana; however, Dana would be able to offset her share of the gain with the unamortized portion of her Code Sec. 743(b) adjustment. In other words, under this structure, Dana obtains flow-through taxation on any growth in the value of the business, does not step into Elliott's double tax problem and obtains tax benefits for her $3,000,000 purchase price.

A couple of items to note. First, it is important that Dana purchases a membership interest in a regarded entity. Assume, for example, that Elliott decided to form an S corporation holding company to which he would contribute the stock of each of the C corporation operating companies, and, in turn, convert each of the C corporation subsidiaries into QSubs in order to provide for future flow-through taxation for himself. If each of the QSubs sell 50% of their respective membership interests in the new LLC to Dana, she would be considered to have purchased membership interests in a disregarded entity (because the S corporation holding company would be considered to be the sole owner of the membership interests by virtue of the disregarded entity status of the QSubs). As discussed in more detail in the Partner's Perspective at ¶9727, such a transaction would be considered an asset purchase by Dana and a partnership formation transaction between Dana and the S corporation holding company, pursuant to Rev. Rul. 99-5, 1999-1 CB 434.

Consequently, because of the asset-by-asset nature of the manner in which Code Sec. 704(c) allocations are made, 50% of the amortization deductions attributable to the $3,000,000 tax basis/$3,000,000 intangible value contributed by Dana would be allocated to the QSubs (and, consequently, the S corporation holding company), and there could be a ceiling rule limitation problem with respect to the zero basis intangible value contributed by the QSubs. As a result, Dana could lose $1,500,000 of potential deductions. The "slippage" potentially can be cured by the adoption of the remedial method of making Code Sec. 704(c) allocations; however, as discussed in the foregoing Partner's Perspective, such method creates potential ordinary income recapture issues in the future for Dana. Consequently, obtaining deductions via a Code Sec. 743(b) adjustment, which only is obtained by purchasing a membership interest in a regarded entity, generally is the way to go. (Thus, if the S corporation holding company/QSub structure is utilized, it will be essential for there to be another regarded entity, in addition to the S corporation holding company, as a member of the newly formed LLC.)

Second, as noted, Elliott has a double tax problem based on his current C corporation structure. An S election can eliminate the problem with respect to future increases in value (and can eliminate the problem with respect to the S corporation holding company's $3,000,000 of built-in gain in its remaining 50% share of the intangible value after the sale to Dana, if the current assets are not sold during the 10-year built-in gains recognition period), but the S election does nothing to help Elliott with respect to the portion of Dana's sale proceeds that he intends to put into his pocket. These proceeds first will be subject to the Code Sec. 1374 built-in gains tax. However, as discussed in the Partner's Perspective at ¶9617 (*see* the discussion of the *Martin Ice Cream* and *Norwalk* cases contained therein), to the extent Elliott could establish that some of the intangible value of the generated by the business operations really belonged to him (e.g., customer lists, relationships, etc.), he could contribute such intangible value to the newly formed LLC and he, too, could be a seller of membership interests. Such sale by Elliott would produce long-term capital gain (as his holding period of the membership interest would be based on his holding period of the contributed intangible value—Code Sec. 1223(1)) and only one level of tax.

### *The Potential Trap and Potential Reappearance of Code Sec. 704(c)*

So far, so good. However, let's take a look at a potential trap that could result by reason of the interaction between Code Secs. 704(b) and 704(c). When each of the corporations contribute their intangible value to the newly formed LLC, their tax capital accounts will be zero; however, their aggregate book capital accounts for Code Sec. 704(b) purposes presumably will be $6,000,000 (based on the $3,000,000 purchase price paid by Dana for a 50% interest in the business operations). When Dana purchases a 50% membership interest, she will step into the shoes of the corporations to the extent of a zero tax basis, $3,000,000 capital account balance. After her $7,000,000 capital infusion into the LLC, she would have a $10,000,000 book capital account balance and a $7,000,000 tax capital account balance, while the corporations would have a $3,000,000 book capital account balance and a zero tax capital account balance. Because Dana will obtain a Code Sec. 743(b) basis adjustment as a result of her purchase of membership interests, and will receive $3,000,000 of amortization deductions over 15 years, the first instinct would be to use the traditional method of making Code Sec. 704(c) allocations with respect to the zero basis intangible value inside the LLC. However, let's examine the potential problems with this instinctive reaction.

Assume, for example, that the LLC generates operating losses equal to Dana's $7,000,000 capital infusion. Because Dana's $7,000,000 capital infusion has a liquidation priority over the other $6,000,000 of capital in the LLC, the first $6,000,000 of loss would be allocated 50% to Dana and 50% to the corporations. This loss allocation would reduce the corporations' book capital accounts to zero and Dana's book capital account from $10,000,000 to $7,000,000. Dana would then be allocated the remaining $1,000,000 of the $7,000,000 loss. For income tax purposes, Dana would be allocated $4,000,000 of the tax loss and the corporations would be allocated $3,000,000 of the tax loss to correspond to the Code Sec. 704(b) book allocations.

Now let's assume that next year the LLC's business fails, resulting in a book loss of its $6,000,000 of intangible value. This entire loss would be allocated to Dana because she is the LLC member with the remaining book capital of $6,000,000. However, there would be no tax deductions to allocate, as the intangible value has a zero tax basis in the hands of the LLC. When the dust clears, Dana will have been allocated a $4,000,000 ordinary tax loss from business operations and would have a $3,000,000 ordinary tax loss attributable to her Code Sec. 743(b) basis adjustment (as the amortizable basis adjustment should result in a Code Sec. 1231 loss), for an aggregate ordinary tax loss of $7,000,000. Her remaining $3,000,000 loss would be capital in character. The corporations, on the other hand, would have been allocated a $3,000,000 ordinary loss from business operations, for which they had no basis or an amount at risk.

A remedial allocation with respect to the intangible value would have solved this problem for Dana. When the loss occurred, a $3,000,000 remedial allocation of ordinary loss would be created for Dana and a corresponding amount of ordinary income would be created for the corporations (to correspond with the corporations' initial Code Sec. 704(c) responsibility in 50% of the intangible value). From Dana's perspective, she would now have $10,000,000 of ordinary loss, thereby eliminating the capital loss problem. From the perspective of the corporations, they would recognize $3,000,000 of ordinary income; however, such income would be offset by the $3,000,000 of ordinary operating losses that previously had been allocated to them.

One might wonder, however, if the corporations wind up with ordinary income recognition from the remedial allocation, if the LLC did not lose $7,000,000 from its business operations. If such loss does not occur, which means that there is no diminution of anyone's capital accounts from business operations, a remedial allocation with respect to intangible value that occurs over 15 years causes there to be cross allocations of income and deductions with no net result. In other words, the $3,000,000 of contributed intangible value for which Dana steps into the shoes of the corporations creates $1,500,000 of book deductions for the corporations, resulting in a $1,500,000 remedial allocation of deductions to the corporations and a $1,500,000 remedial allocation of income to Dana. However, the opposite occurs with respect to the corporations' remaining 50% interest in the goodwill. As a result of these cross allocations, no net taxable income or loss is recognized by either Dana or the corporations with respect to the amortization of the intangible value.

Assuming flat operations, at the end of 15 years, the corporations' book capital accounts will have been reduced to zero and Dana's book capital account will have been reduced from $10,000,000 to $7,000,000 (by the allocation of $3,000,000 of book amortization deductions to the corporations on one hand, and Dana on the other). Now, if there is an ordinary loss from operations, there is no slippage away from Dana to the corporations because the corporations do not have capital account balances to support a loss allocation. If an ordinary loss from operations occurs before the remedial allocation is completed and the corporations receive an allocation of ordinary loss to the extent of their remaining positive capital account balances, Dana will receive the remaining book deductions from the amortization that otherwise would have been allocated to the corporations (by virtue of her $7,000,000 remaining capital account balance), and there will be a remedial allocation of income to the corporations and a remedial allocation of deductions to Dana.

Cutting through the complexity, the remedial allocation should not produce any net ordinary income recognition to the corporations. This method is a backstop to offset any ordinary deductions that are allocated to the corporations by virtue of its Code Sec. 704(b) capital account that was created on the contribution of the intangible value that had no tax basis, but for which it received capital account credit.

Not such a garden-variety transaction after all—a real trap for the unwary!

F:\DOCS\CL\15001\02\Columns of 2008\2-08.doc