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"Partnering" With an S Corp.

By Louis Vlahos

Why, Oh Why? We've heard it before: "Why would you choose to operate as an S corporation?"

Underlying this question is a number of other business-related questions, among which are the following:

- *Why would you limit the types of investors from whom you could accept equity capital contributions?* Non-U.S. individuals, partnerships and other corporations cannot own equity in the S corporation without causing it to lose its tax-favored status. In addition, only certain kinds of trusts can own shares in an S corporation; in many cases, the trust, or its beneficiary, must make a special election in order to qualify the trust as a shareholder.
- *Why would you limit the type of equity interests that you can issue to an investor?* S corporations can only have one class of common stock issued and outstanding – all of its shares must have identical economic rights. Thus, preferred shares of stock are not permitted, nor are special allocations of income and loss. Many potential investors, however, will require a special return on and/or of their investment to compensate them for the use of their capital or for the risk they are assuming.
- *Why would you limit the number of shareholders?* An S corporation cannot have more than 100 shareholders. Although special counting rules have alleviated this limitation in the case of family-owned corporations, other S corporations, with growing businesses, may have to confront this ceiling.

These are valid concerns that, in the case of a newly formed business enterprise, may cause the owners to operate, at least initially, through an LLC that is treated as a partnership for tax purposes, rather than through an S corporation.

Caught between Scylla and Charybdis?

The fact remains, however, that there are many S corporations in existence. Although an S corporation may "convert" into a partnership, the conversion, regardless of the form by which it is affected, will be treated as a liquidation for tax purposes. Thus, its shareholders will be taxed as though the corporation's assets (including goodwill) had been distributed to them, as part of a taxable sale and liquidation, in exchange for their shares. If the corporation is subject to the built-in gains tax, it will incur a corporate level tax.

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Alternatively, the S corporation can free itself of the above limitations by revoking its election to be taxed as an S corporation. Of course, this will cause the corporation to be taxed as a C corporation: its profits will be subject to a corporate level tax and, when these after-tax profits are distributed to its shareholders, the shareholders will also be subject to tax.

What's an S Corp. to do?

Thankfully, there are situations where the choices are not as bleak, as a recent IRS letter ruling (PLR 201544020) illustrated.

X Corp. was an S corporation. Y Corp. and Z Corp. were also S corporations. X Corp. had close to 100 shareholders.

The shareholders of X Corp. planned to restructure its business by undertaking several steps, the result of which would be that X would become a general partnership under state law, and Y and Z together would own all of the interests in X (the "Restructuring"). The shareholders of X would become shareholders in either Y Corp. or Z Corp., and Y and Z would be governed by identical boards of directors pursuant to a voting agreement entered into by their shareholders.

Following the Restructuring, the parties anticipated that both Y Corp. and Z Corp. would issue additional shares to new shareholders over time, so that while the total number of shareholders in Y and Z together might exceed 100 neither Y nor Z would separately have more than 100 shareholders.

The ruling

The IRS reviewed one of its published rulings (Rev. Rul. 94-43) in which unrelated individuals entered into the joint operation of a single business. The individuals divided into three equal groups and each group formed a separate S corporation. The three corporations then organized a partnership for the joint operation of the business. The principal purpose for forming three separate corporations, instead of one corporation, was to avoid the 100-shareholder limitation for qualification as an S corporation and thereby allow the corporations to elect to be treated as S corporations.

In an earlier published ruling (Rev. Rul. 77-220), the IRS had concluded, based on the same facts, that the three corporations should be considered to be a single corporation for purposes of making the election, because the principal purpose for organizing the separate corporations was to make the election. Under this approach, the election made by this "single" corporation would not be valid because the shareholder limitation would be violated. In reconsidering the prior ruling, the IRS concluded that the election of the separate corporations should be respected. The purpose of the "number of shareholders" requirement, it said, was to restrict S corporation status to corporations with a limited number of shareholders so as to obtain administrative simplicity in the administration of the corporation's tax affairs. In this context, administrative simplicity was not affected by the corporation's participation in a partnership with other S corporation partners; nor should a shareholder of one S corporation be considered a shareholder of another S corporation simply because the S corporations are partners in a partnership.

Thus, the fact that several S corporations were partners in a single partnership did not increase the administrative complexity at the S corporation level. As a result, the purpose of the "number of shareholders" requirement was not avoided by the partnership structure and, therefore, the S elections of the corporations should be respected.

Accordingly, the IRS concluded in the letter ruling that Y and Z would continue to meet the S corporation requirements subsequent to the Restructuring, so long as neither Y nor Z exceeded 100 shareholders each.

Other applications?

The above ruling indicates that the 100 shareholder limit may not be insurmountable if the business of the S corporations is conducted through a partnership.

Would the same strategy apply with respect to the single class of stock requirement? What about the restriction as to who may be a shareholder? The answer in most cases should be "yes."

For example, A Corp. and B form partnership PRS to conduct a bona fide business. A contributes business assets to PRS, and B contributes cash, in a tax-free exchange for partnership interests in PRS. A is an S corporation. B is a nonresident alien. Because the S corporation rules prohibit B from being a shareholder in A Corp., A and B chose the partnership form, rather than admit B as a shareholder in A, as a means to retain the benefits of S corporation treatment for A Corp. and its shareholders.

According to the IRS, the partnership tax rules are intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an

entity-level tax. The decision to organize and conduct business through PRS is consistent with this intent. (See Treas. Reg. Sec. 1.701-2.)

It is important to note, however, that the form of the partnership transaction may not be respected if it does not reflect its substance – application of the substance over form doctrine arguably could, depending on the facts, result in B being treated as a shareholder of A Corp., thereby invalidating A's S corporation election. Thus, the form in which the arrangement is cast must accurately reflect its substance as a separate partnership and a separate S corporation. At the very least, there should be a bona fide business purpose for forming the partnership.

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