

Consideration	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company
Deduction of Interest on Debt Utilized to Purchase Equity Interest	Interest on money borrowed by a shareholder to purchase stock may be deductible as investment interest. Deduction as business interest has been denied when the corporation, rather than the stockholder, owned the business. <u>Russon v. Commissioner</u> , 107 T.C. No. 15 (1996).	Interest on debt incurred to acquire an ownership interest in a pass-through entity is investment interest only to the extent allocated to the portion of the corporate assets comprised of portfolio or other investment assets. However, a business interest deduction will be allowed for interest on money borrowed to purchase an ownership interest if the purchaser materially participates in the activity's trade or business, but only to the extent that the entity's assets produce active trade or business income. ¹	Same as S corporation.	Same as S corporation.	Same as S corporation.

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For example, if an S corporation shareholder materially participates in the S corporation's business, the shareholder will be allowed a business deduction for interest incurred to purchase his shares. However, if the entity owns nonoperating assets of a trade or business, such as a rental property, a portion of the interest expense will have to be allocated to passive activities and that portion cannot be deducted as a business interest. Query, what if shareholder is a real estate professional? On the other hand, if the shareholder does not materially participate in the S corporation's activities, the interest expense allocated to the trade or business assets is reported as a passive activity and either decreases passive activity income or increases passive activity loss on the shareholder's return. See Temp. Reg. §1.163-8T.

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Subject to Passive Activity Rules Under §469 ²	Generally no, but there are special rules for personal service corporations and closely held corporations. ³	The PAL rules applied at the shareholder level.	The PAL rules applied at the partner level.	The PAL rules applied at the partner level. A limited partner who is not a general partner will generally be subject to the PAL rules if the partnership has passive losses. Special exception apply to limited partners. ⁴	Although the passive loss rules do not specifically address LLCs, the PAL rules should apply at the member level. Not clear if members will be treated as general or limited partners. If a member/manager is treated as a general partner, he should be able to demonstrate material participation in various other ways as well. ⁵

58 Restricts a taxpayer's ability to take losses derived from trades or businesses in which they do not materially participate.

59 In those instances where the passive loss rules apply, a closely held C corporation or personal service corporation will be treated as materially participating in an activity only if stockholders owning more than 50 percent in value of the stock materially participate, or in the case of a closely held C corporation which is not a personal service corporation, certain other requirements are met. IRC §5469(h)(4).

60 A limited partner who meets one of three material participation tests may escape passive loss treatment. Temp. Reg. §§1.469-5T(a)(l), (5)-(6), (e)(2).

61 Presumably, then, in one of three ways provided in the regulations, a member with limited liability who materially participates in the LLC business should be able to avoid the passive loss limitations. Temp Reg. §1.469-ST(a)(2)-(4), (7).

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Subject to At-Risk Rules Under §465	Only applies to C corporation if more than 50% of stock is owned by 5 or fewer individuals.	Apply at shareholder level.	Apply at partner level.	Apply at partner level.	Apply at member level.
Entity Debt Included In Basis	Debt not included in shareholder's basis	Debt not included in basis of shareholders' stock, except to the extent corporation is indebted to the shareholder.	Debt included in the owners' basis in their interests, subject to limitations relating to debt for which the partner/member is not personally liable.	Same as General Partnership.	Same as General Partnership, except unlike a partnership, all debt should be considered nonrecourse to the members, unless a member or third party has agreed to be personally liable. ⁶
Effect of Debt Transfer	Reduces stock basis but is included in entity basis; gain recognized where debt exceeds transferred asset basis; all debt treated as distribution of money where principal purpose of any portion of debt transfer is tax avoidance. IRC §§ 358(a)(1)(A)(ii), 358(d), 362, 357(c), 357(b).	Same as C Corporation.	Net changes in share of debt affect member basis (decrease is constructive distribution of money that decreases basis and is taxable to extent it exceeds basis, and increase is constructive contribution of money that increases basis) but included in partnership basis. IRC §§ 722, 733, 731, 752.	Same as General Partnership.	Same as General Partnership.

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Hence, it should be easier for members of an LLC to receive an allocation of basis for entity-level recourse debt guaranteed by unrelated third parties than for limited partners, because the recourse liability of a limited partnership may have to be allocated to the general partner after the limited partners' capital accounts have been exhausted.

Consideration	C Corporation	S Corporation	General Partnership	Limited Partnership	Limited Liability Company
Effect of Debt to Owners	Risk of equity recharacterization resulting in recasting interest payments as dividends and retirement payments as dividends versus return of capital. IRC §385.	Second class of stock owner obtains debt (and stock) basis only for direct loans to entity that exclude economic equivalents such as owner guarantees of entity debt. IRC § 1362(d)(2); (<u>Harris v. United States</u> , 902 F2d 439 (5 th Cir. 1990)).	Nonrecourse partner loan increases only lending partner's basis; recourse partner loan is included in each partner's basis to extent each bears economic risk of loss for the loan (lending partner's basis therefore includes only a portion of loan). Treas. Reg. §§ 1.752- 2(a), a.752-2(c).	Same as general partnership, except that limited partner recourse loans increase only general partner's basis (e.g. <u>Kingbay v. Commr.</u> , 46 TC 147 (1966)).	Nonrecourse member loan increases only lending member's basis; recourse member loans generally included in each member's basis according to profit-sharing ratios (lending member's basis therefore includes only portion of loan). Treas. Reg. §§ 1.752- 2(a), 1.752-2(c).
Application of Self-Employment Tax to Owners	None, except to the extent paid out to the shareholder as compensation.	Shareholder is liable only to the extent paid out as compensation. Distributed and undistributed earnings not subject to tax. ⁷	All individual partners subject to self-employment tax on share of earnings if earnings are from self-employment.	Individual general partners subject to self employment tax. Limited partners are generally subject to self employment tax only to the extent of guaranteed payments received or for compensation received as service partners. See IRC §1402(a)(13) and Prop. Reg. §1.1402(a)-2(g). ⁸	Application to non-managing member is not clear. Under Prop Reg. § 1.1402(a)-2(i) a member is not subject to SE tax to the extent that such member is not a manager and the entity could have been formed as a limited partnership and the member could have been a limited partner.

⁶³ See Comiter, "Reasonable Compensation: Dividends vs. Wages - A Reversal of Positions", Journal of Partnership Taxation (Winter, 1991); the IRS has taken the position that a reasonable amount of compensation must be paid to the shareholder if distributions are made. See Spicer Accounting, Inc., 91-1 USTC ¶50,103 (9th Cir. 1990); Radtke, 90-1 USTC ¶50,113 (7th Cir. 1990).

⁶⁴ As a result of the many comments and protests regarding the 1997 proposed regulations, Section 935 of the Taxpayer Relief Act of 1997 placed a moratorium until July 1, 1998 on the IRS' issuance of regulations with respect to the self-employment taxation of limited partners. To date, no regulations have been issued.

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Unreasonable Compensation Issues	Yes	Generally none, unless too small in order to avoid employment tax.	Generally none.	Generally none.	Generally none
Fringe Benefits to Owner Employees	Shareholder-employees can receive certain fringe benefits, such as health insurance, even though payment is deductible by corporation..	Owner of more than 2% of entity generally cannot receive tax-free fringe benefits.	Same as S Corporation.	Same as S Corporation.	Same as S Corporation.
Retirement Plans	Flexible with non-discriminatory rules and top-hat rules.	Flexible with non-discriminatory rules and top-hat rules.	Participate in Self-Employed Plans.	Participate in Self-Employed Plans.	Participate in Self-Employed Plans.
Entity Owner's Ability to Borrow From Qualified Plans	A shareholder's degree of ownership of stock does not affect his ability to borrow from the qualified plan, if the loan provisions of the plan are properly structured. IRC §4975(d)(1).	A shareholder who owns more than 5% of the corporation cannot borrow from the corporation's qualified plan. IRC §4975(d).	Same as Limited Liability Company.	Same as Limited Liability Company.	An individual cannot borrow from the entity's qualified plan if the individual owns a 10% or more capital interest or profits interest. IRC §§4975(d), 401(c)(3).
Availability of Qualified Real Property Business Indebtedness Exception to COD Rules Under IRC §108(c)	Not available	Available	Available	Available	Available
Cancellation of Debt Exceptions Determined at Entity or Owner Level	Corporate level	Corporate level. §108(d)(7).	Partner level. §108(d)(6).	Partner level. §108(d)(6).	Member level. §108(e)(6).

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Availability of Non-Interest Bearing or Below Market Rate “Loans” from owner	No. Must impute interest under IRC §7872 or determine OID under IRC §1271 et. seq.	No. Must impute interest under §7872 or determine OID under §1271 et. seq.	Same as Limited Liability Company	Same as Limited Liability Company	Yes if treated as capital contribution. ⁹
Use for Holding Real Estate.	Not desirable due to double tax and no flow-through of losses.	Not desirable because no special allocation of income and no inclusion in basis for corporate debts.	Desirable for tax reasons but no liability protection, unless use LLP status.	This has been the entity of choice. Use LLP status.	May become the entity of choice because of the total liability protection, avoidance of double tax, and the inclusion in basis of the debts of the LLC.
Effect of Donor’s Retention of Right to Vote Gifted Entity Interest	If the donor’s family owns at least 20% of the corporation, the donor cannot retain voting rights in gifted stock without adverse estate tax consequences. IRC §2036(b).	Same as C Corporation, but consider recapitalization and gift of non-voting stock to avoid IRC §2036(b) estate inclusion issue.	Same as Limited Liability Company	Same as Limited Liability Company	Section 2036(b) does not apply to the retention of voting rights with respect to gifted interests in partnerships.
Available as a Controlled Entity for the Development of Presently Owned Real Estate ¹⁰	Generally not because of double tax.	Generally used because of the clear separate entity and the avoidance of double tax.	Not available because sale of noncapital asset to partnership would produce ordinary income under §707(b).	Not available because sale of noncapital asset to partnership would produce ordinary income under §707(b).	Not available because sale of noncapital asset to partnership would produce ordinary income under §707(b).

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⁶⁵ A partner may be paid a “guaranteed payment” for the use of capital invested. IRC §707(c).

⁶⁶ An individual or partnership may own real estate that has appreciated in value. If the property is subdivided and sold, the gain may be ordinary income rather than capital gain. In an attempt to realize as much capital gain before development, it may be possible to sell the property to a controlled entity which does the development. See Bramblett, 92-1 USTC ¶150,252 (5th Cir. 1992), revg. 50 TCM 876 (1990); and Bradshaw, 82-2 USTC ¶9454 (Ct. Cl. 1982).

