

# S corporations: A Cautionary Tale about Squaring the Circle

**LLCs, LPs and Partnerships**  
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## 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

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## 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(l)(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(l)(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   |

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## 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 <sup>th</sup> 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    |

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## 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 NII        | <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        |

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