



Agricultural Law Press

Publisher/Editor

Robert P. Achenbach, Jr.

Contributing Editor

Dr. Neil E. Harl, Esq.

* * * *

Issue Contents

Bankruptcy

Chapter 12

Eligibility **179**

Contracts

Implied warranty of fitness for consumption **179**

Federal Agricultural Programs

Agricultural economics **179**

Brucellosis **179**

Business and industry guaranteed loan program **179**

Farm labor **179**

PACA **179**

Federal Estate and Gift Taxation

Administrative expenses **180**

Gross estate **180**

Valuation **180**

Federal Income Taxation

Automobile expenses **180**

Bad debts **180**

Capital assets **181**

Dependents **181**

Earned income credit **181**

Employee benefits **181**

Employee expenses **181**

Hobby losses **181**

Involuntary conversions **182**

Mileage deduction **182**

Passive activity losses **182**

Pension plans **182**

Returns **182**

S corporations

Employee **182**

Trusts **183**

Safe harbor interest rates

December 2004 **183**

Social security tax **183**

State Regulation of Agriculture

Warehouses **183**

Product Liability

Herbicides **183**

Agricultural Law Digest

Volume 15, No. 23

November 26, 2004

ISSN 1051-2780

Incorporating a Partnership

-by Neil E. Harl*

For some time, the incorporation of partnerships has been governed largely by Rev. Proc. 84-111¹ which has provided that a partnership can be incorporated under any one of three alternative methods. Each method has been accompanied by unique income tax consequences.²

In late May, 2004, the Internal Revenue Service issued a revenue ruling, Rev. Rul. 2004-59,³ outlining a procedure for converting a partnership to a corporation under a state law "formless conversion statute" with the transfer not subject to Rev. Rul. 84-111.⁴

General rule

Under Rev. Rul. 84-111,⁵ incorporation of a partnership can be handled in three different ways:

- Under the first approach, the partnership transfers its assets to the corporation in exchange for stock and securities that are distributed to the partners in the partnership's liquidation.⁶ Gain or loss is not recognized by the partnership on the transfer to the corporation.⁷ The corporation's income tax basis in the assets received equals their basis in the hands of the partnership immediately before the transfer.⁸ The income tax basis to the partnership of the stock received from the corporation is the same as the basis to the partnership of the assets transferred, reduced by any liabilities assumed by the corporation.⁹ The assumption by the corporation of the partnership's liabilities decreases each partner's share of partnership liabilities, thus decreasing the income tax basis of each partner's partnership interest.¹⁰ On distribution of the stock to the partners, the partnership terminates.¹¹ The income tax basis of the stock distributed in liquidation of the partnership equals the adjusted basis of the partner's interest in the partnership.

The partnership's holding period for the stock received in the exchange includes its holding period in the capital assets and Section 1231 assets transferred (to the extent the stock was received in exchange for such assets). To the extent the stock was received in exchange for neither capital assets nor Section 1231 assets, the partnership's holding period begins on the day following the exchange.

The corporation's holding period in the assets transferred includes the partnership's holding period. The distribution of stock to the partners does not violate the control requirement of I.R.C. § 368(c).¹²

- Under the second approach, the partnership distributes its assets to the partners upon liquidation of the partnership and the partners simultaneously transfer the assets to the corporation in exchange for stock and securities of the corporation. Upon termination of

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

the partnership, the income tax basis of assets (other than money) distributed to the partners is equal to the adjusted basis of the partner's interest in the partnership reduced by any money distributed.¹³ The decrease in partnership liabilities resulting from the transfer to partners is offset by the partners' corresponding assumption of the liabilities so the net effect on the income tax basis of each partner's interest in the partnership with respect to liabilities transferred is zero. Neither gain nor loss is recognized by the transfer of assets from the partners to the corporation in exchange for stock and securities and the assumption of liabilities from the partnership.¹⁴

The income tax basis of the stock received from the corporation is the same as the basis to the partners in the assets received in the partnership liquidation and transferred to the corporation, reduced by the liabilities assumed by the corporation.¹⁵ The assumption of liabilities is treated as a payment of money to the partners.¹⁶

The corporation's income tax basis in the assets received from the partners equals their income tax basis to the partners immediately before the transfer to the corporation.¹⁷ The partners' holding period for the assets distributed by the partnership includes the partnership's holding period.¹⁸ The partners' holding periods for the stock received in the exchange includes the partners' holding periods in the capital assets and Section 1231 assets transferred to the corporation (to the extent the stock was received in exchange for such assets).¹⁹ However, to the extent the stock received is in exchange for neither capital assets nor Section 1231 assets, the holding period for the stock begins on the day following the exchange.

The corporation's holding period for the assets received in the exchange includes the partners' holding periods.

- With the third approach, the partners transfer their partnership interests to the corporation in exchange for stock and securities followed by termination of the partnership. Neither gain nor loss is recognized by the partners in the partnership upon transfer of the partnership interests to the corporation in exchange for stock and securities.²⁰ Upon transfer of partnership interests to the corporation, the partnership terminates.²¹

The income tax basis to the partners of the stock received from the corporation in exchange for their partnership interests equals the income tax basis of their partnership interests transferred to the corporation, reduced by partnership liabilities assumed by the corporation.²² The release of liabilities is treated as a payment of money to the partners.²³ The corporation's income tax basis for the assets received in the exchange equals the income tax basis of the partners in their partnership interests, allocated in accordance with the statutory requirements.²⁴ The corporation's holding period includes the partnerships' holding period in the assets.

The holding period of the corporate stock received by the partners includes each respective partner's holding period for the partnership interest transferred, except that the holding period for the corporate stock received by the partners in exchange for their interests in Section 751 assets of the

partnership that are neither capital assets nor Section 1231 assets begins on the day following the exchange.²⁵

Rev. Rul. 2004-59

Under the new guidance,²⁶ if an unincorporated state law entity that is classified as a partnership for federal tax purposes converts to a state law corporation under a state statute that does not require an actual transfer of the unincorporated entity's assets or interests (referred to as a state law "formless conversion statute"), the entity is treated as one that makes an election to be treated as an association.²⁷ The conversion is deemed to proceed in two steps— (1) the unincorporated entity contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation and (2) the unincorporated entity immediately liquidates, distributing the stock of the corporation to its partners.²⁸ *Rev. Rul. 84-111*²⁹ does not apply to the conversion if done in accordance with a state law "formless conversion statute."³⁰

FOOTNOTES

¹ 1984-2 C.B. 88. See generally, 8 Harl, *Agricultural Law* § 60.05[6][c] (2004); Harl, *Agricultural Law Manual* § 7.02[2][c] (2004).

² *Id.*

³ I.R.B. 2004-24.

⁴ *Id.*

⁵ 1984-2 C.B. 88.

⁶ *Id.*

⁷ I.R.C. § 351.

⁸ I.R.C. § 362(a).

⁹ I.R.C. §§ 358(a), 358(d).

¹⁰ See I.R.C. §§ 733, 752.

¹¹ I.R.C. § 708(b)(1)(A).

¹² See *Rev. Rul. 84-111*, 1984-2 C.B. 88.

¹³ I.R.C. § 708(b)(1)(A).

¹⁴ I.R.C. § 351.

¹⁵ I.R.C. §§ 358(a), 732(b).

¹⁶ I.R.C. § 358(d). I.R.C. § 358(d).

¹⁷ I.R.C. § 732(c).

¹⁸ I.R.C. § 735(b).

¹⁹ I.R.C. § 1223(1).

²⁰ I.R.C. § 351.

²¹ I.R.C. § 708(b)(1)(A).

²² I.R.C. § 358(a).

²³ See I.R.C. §§ 752(d), 358(d).

²⁴ I.R.C. § 732(c).

²⁵ I.R.C. § 1223(1).

²⁶ *Rev. Rul. 2004-59*, I.R.B. 2004-24.

²⁷ *Id.* See *Treas. Reg. § 301.7701-3(c)(1)(i)*.

²⁸ *Rev. Rul. 2004-59*, I.R.B. 2004-24.

²⁹ 1984-2 C.B. 88.

³⁰ *Rev. Rul. 2004-59*, I.R.B. 2004-24.