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THE START-UP PARTNERSHIP AND ITS SUBSEQUENT INCORPORATION: FEDERAL INCOME TAX ISSUES REEXAMINED

David W. Herbst*

I. INTRODUCTION

A new business enterprise has a variety of forms of entity available through which to conduct its business activities. The forms of entity currently available include general partnerships,[1] limited partnerships,[2] business trusts,[3] C corporations,[4] and S corporations.[5] The form and specific structure of the entity in which a new business enterprise operates is determined by a number of factors. These factors include the interests and concerns of those who will provide capital to the business, those persons who will provide entrepreneurial know-how and other property rights to the business, and those persons who will provide vital services to the business.

Among the issues to be resolved in the structure of a new business enterprise are the respective rights of the persons in each of these groups to the assets of the business, their respective rights to the profits of the business, their respective responsibilities for losses and liabilities of the business, and their respective rights and obligations with respect to the management and control of the business.

In most cases, the agreements among such parties on these structural matters can be accommodated through more than one form of business entity. While the parties' relationships among themselves may be similarly structured in various forms of business

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1. For example, a partnership as defined in CAL. CORP. CODE § 15006 (West 1977) that is not a limited partnership.

2. For example, a limited partnership is formed pursuant to CAL. CORP. CODE § 15621 (West Supp. 1987).

3. For example, a business trust formed pursuant to MASS. GEN. LAWS ANN. Ch. 182.

4. A corporation taxable under Subchapter C of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986.

5. A corporation validly electing to be governed by Subchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986.

entity, the federal income tax consequences to one or more of the parties from the operation of the business enterprise may vary significantly depending upon which of the various forms of entity is chosen. For this reason, the form of entity a particular business enterprise chooses may be heavily dependent upon the federal income tax consequences.

The forms of entity most commonly utilized for start-up companies are the corporation and the limited partnership. Both of these forms provide limited liability to capital investors and the centralization of management functions. Both permit a wide variety of economic arrangements among owners through the use of classes of stock or partnership interest. The decision as to which of these two forms of entity to use for a particular start-up company is often dictated by federal income tax considerations.

In many cases, the choice is not between using the limited partnership form or the corporate form. Rather, a particular enterprise may utilize both the corporate form and the limited partnership form, either simultaneously or at different times during its existence. For example, it has been common for a start-up company to operate initially as a limited partnership. This enables investors in the company to deduct from personal income losses incurred from business operations during the start-up phase. Subsequently the company operates as a corporation when the business enterprise becomes profitable, so that the investors are not taxed on income retained in the business enterprise which is unavailable to them for payment of taxes.[6]

During the period that a start-up company is operated as a limited partnership, it is customary for the limited partnership to have a corporation as a general partner. The presence of a corporate general partner offers some additional liability protection for those persons who are managing the business. This tactic may also offer some federal income tax advantages to entrepreneurs providing basic technology or other property to the business enterprise and to the persons performing services for the business enterprise.

The use of multiple business entities and the changes in form of entity add legal, accounting, and administrative complexity to the operation of the business enterprise. Early in the formation of the business enterprise, it is necessary for the parties to determine

6. The federal income tax implications of various methods of changing from limited partnership form to corporate form are described in Revenue Ruling 84-111, 1984-2 C.B. 88. *See* S. Kramer and J. Kramer, *Incorporation of a Partnership: IRS's New Position Produces Planning Opportunities and Pitfalls*, TAXES—THE TAX MAGAZINE, Sept. 1986.

whether the income tax benefits that are potentially available from such arrangements outweigh the effort and expense of creating such a structure and operating under it. In the past, the federal income tax benefits from such arrangements have been substantial and have more than compensated for the additional cost incurred as a result of the complexity of the arrangement in many instances. However, recent changes to the Internal Revenue Code,[7] including the enactment of the Tax Reform Act of 1986,[8] and changes in the interpretation of such laws have significantly diminished the tax benefits to be derived from such arrangements.

This article reviews the federal income tax issues involved in selecting the form of entity for a start-up company at its inception and at subsequent stages in its business life. Particular attention will be focused on the effect of recent tax developments upon the federal income tax aspects of operating as a limited partnership versus operating as a C corporation at various stages during the development of the business enterprise and the federal income tax implications of changing the form of entity at various points in the life of the business enterprise.

Many of the same federal income tax benefits available to a business enterprise starting out as a limited partnership and subsequently incorporating are available solely from the use of a corporation. These benefits are available if the corporation is eligible to make a Subchapter S election for the period of time that operation of the business as a limited partnership would be appropriate.[9] However, a number of the restrictions imposed on S corporations are not compatible with the business expectations of capital investors in a start-up high technology company.

Because of the economic risks involved in a start-up high technology company, capital investors in such enterprises operated as corporations generally acquire a preferred class of stock or other securities having rights and preferences over stock in the company held by entrepreneurial founders and persons performing services. A corporation that has more than one class of stock is not permitted to be an S corporation.[10] If the capital investors were to hold secur-

7. "I.R.C." hereinafter refers to the Internal Revenue Code of 1986, as enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, October 22, 1986. The Internal Revenue Code of 1954, as amended, in effect immediately prior to the enactment of the Tax Reform Act of 1986 is hereinafter referred to as the "former I.R.C.".

8. The Tax Reform Act of 1986, Pub. L. No. 99-514, October 22, 1986, is hereinafter referred to as the 1986 Tax Act.

9. Subchapter S of Chapter 1 of Subtitle A of the I.R.C..

10. I.R.C. § 1361(b)(1)(D) (1984).

ities other than stock, they would not receive the benefit of the pass through of losses pursuant to a Subchapter S election.[11]

Additionally, much of the capital investment in start-up high technology companies is made through venture capital partnerships. This is intended to reduce the capital investor's economic risk by permitting reliance upon the expertise of the venture capitalist in selecting companies for investment as well as permitting diversification of the investment among a variety of companies. A corporation is not eligible to be an S corporation if it has any shareholder who is not an individual,[12] thus precluding any corporation that has a venture capital partnership as a shareholder. An S corporation is not permitted to have any nonresident aliens as shareholders.[13] This restriction precludes an S corporation from utilizing foreign equity capital. Because of these restrictions on the utilization of the S corporation form of entity, this article will address only the choice between the limited partnership form and the C corporation form.

II. Early Operation as Limited Partnership

Start-up companies are often formed as limited partnerships. This permits the capital investors to reduce their personal taxable income by their share of losses incurred by the companies during the early years of operations. Deductible items generating such losses include research and development expenditures[14] and business expenditures incurred by a company in excess of its revenues after its business operations have commenced, but before it becomes profitable.[15]

Losses incurred by a company operated in limited partnership form are allocable by the partnership to its partners.[16] Such losses

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11. I.R.C. § 1366(a) (1984).

12. I.R.C. § 1361(b)(1)(B) (1984).

13. I.R.C. § 1361(b)(1)(C) (1984).

14. Under I.R.C. § 174, a taxpayer may elect to deduct certain research and experimental expenditures paid or incurred by the taxpayer in connection with a trade or business, even before the taxpayer has entered into a trade or business. *See* Snow v. Commissioner, 416 U.S. 500 (1974).

15. Ordinary and necessary expenses paid or incurred in carrying on a trade or business are deductible under I.R.C. § 162. Expenses incurred by a start-up company prior to the commencement of business are not deductible, but may be amortized over a period of not less than 60 months if the taxpayer so elects under I.R.C. § 195.

16. I.R.C. §§ 704(a) and (b)(2) provide that each partner's distributive share of partnership items will be determined by the partnership agreement if such allocations have substantial economic effect. I.R.C. § 704(b) allocates partnership items in accordance with the partners' interest in the partnership, determined by taking into account all facts and circumstances, if the partnership agreement does not provide an acceptable method of allocation.

offset the partners' income on their personal income tax returns to the extent of their investment in the partnership.[17] Start-up companies operated in limited partnership form generally allocate a substantial portion of such early year losses to the capital investors.[18] The tax benefit of such losses available to the capital investors through the limited partnership form reduces the after-tax cost of their investment in the company below the comparable cost of investing in the same company if operated as a corporation.

Several recent changes to the federal income tax laws will reduce the tax benefit most capital investors receive from their share of a start-up company's early year losses passed through the limited partnership form of entity. These changes in the law include a new limitation adopted by the 1986 Tax Act on the deductibility of losses from certain business activities in which the taxpayer is a passive investor and certain limitations on the use of the cash method of accounting contained in the 1984 Tax Act[19] and the 1986 Tax Act.

A. *Limitation on Losses from Passive Business Activities*

The 1986 Tax Act added Section 469 to the I.R.C.,[20] which places a limitation on the deductibility of losses and the availability of tax credits to individuals, estates, trusts, personal service corporations and closely held corporations from passive activities.[21] The term "passive activity" is defined as any activity which involves the conduct of a trade or business in which the taxpayer does not materially participate.[22] This includes any activity involving research or experimentation, within the meaning of I.R.C. Section 174 permit-

17. The "at-risk" limitation contained in I.R.C. § 465 restricts an investor's deduction of such losses to the sum of the money and adjusted basis of other property contributed by the investor to the company and any amounts borrowed for use by the company to the extent that the investor (or property of the investor outside of the company) is personally liable for repayment.

18. Losses not exceeding the amount of money contributed by the capital investors can generally be allocated to them without exceeding the at-risk limitation of I.R.C. § 465 or violating the substantial economic effect requirement of I.R.C. § 704(b)(2). *See* Treas. Regs. §§ 1.704-1(b)(2)(d) and 1.704-1(b)(5), Example 16.

19. References herein to the "the 1984 Tax Act" are to the Revenue Provisions of the Deficit Reduction Act of 1984 (H.R. 4170, 98th Congress; P.L. 98-369).

20. Added by § 501 of the 1986 Tax Act, I.R.C. § 469 is effective January 1, 1987, with respect to investments made on or after October 22, 1986, in passive business activities. With respect to investments made before October 22, 1986, the limitation is phased in over a five year period, with 65% of any net loss from such activities being deductible in 1987, 40% being deductible in 1988, 20% in 1989, 10% in 1990, and 0% in 1991 and thereafter. 1986 Tax Act, § 501(c).

21. I.R.C. § 469(a) (1987).

22. I.R.C. § 469(c)(1) (1987).

ting the deduction of expenses incurred in such activity.[23]

A taxpayer materially participates in an activity only when the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis.[24] Except as may be provided in regulations, a taxpayer's interest as a limited partner in a limited partnership will not be treated as an interest with respect to which the taxpayer materially participates.[25]

The passive activity loss limitation prevents or defers the deduction of losses generated by a passive activity against income generated from any source other than a passive activity. If a start-up company is operated in limited partnership form, the capital investors, as limited partners or other passive investors, will be able to deduct losses allocated to them by the partnership only at such times and to such extent as the passive activity loss limitation permits.

If a taxpayer invests in a passive activity that generates income in any year, the taxpayer may deduct his losses from passive activities to the extent of such income.[26] A taxpayer's losses from passive activities in excess of the taxpayer's income from passive activities in any given year may not be deducted.[27] Rather, they are carried over to subsequent years until either the loss is deducted against passive activity income in a subsequent year or the taxpayer disposes of the passive activity which generated the loss.[28] During the year the taxpayer disposes of the passive activity that generated a loss which is being carried over, the remaining loss is deductible in full in such year of disposition, first against any income from that passive activity, including gain recognized on disposition, next against income from other passive activities, and the balance against any other income or gain.[29]

The limitation prevents a taxpayer from deducting passive activity losses against the income he receives for rendering services[30] or against his interest income, dividend income, royalty income, or other portfolio income (that is, income from passive investments

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23. I.R.C. § 469(c)(5) (1987).
24. I.R.C. § 469(h)(1) (1987).
25. I.R.C. § 469(h)(2) (1987).
26. I.R.C. § 469(d)(1) (1987).
27. I.R.C. § 469(a)(1) (1987).
28. I.R.C. § 469(b) (1987).
29. I.R.C. § 469(g) (1987).
30. Passive activity losses are not deductible against compensation income, even if such income is received for services rendered in the activity generating the losses. I.R.C. § 469(e)(3) (1987).

which do not involve the conduct of a trade or business) prior to the year that the taxpayer disposes of his interest in the passive activity.

This limitation also applies to income tax credits.[31] If a taxpayer is allocated the right to any tax credit from a passive activity, the tax credit may be applied only against income tax liabilities attributable to income from the passive activity and other passive activities.[32] A taxpayer may carry forward any disallowed tax credit and use it in a subsequent year or years to offset income tax liabilities attributable to passive activity income.[33] However, a disallowed tax credit does not become fully available by reason of the taxpayer's disposition of his interest in the passive activity which generated the tax credit.

A capital investor who is a limited partner in a start-up high technology company operated as a limited partnership may deduct his share of the company's federal income tax losses only to the extent of his share of income generated by the start-up company and his income from other passive activities. Additionally, the investor may use his share of any tax credits from such activity only to the extent of his tax liability attributable to such income. If the capital investor does not hold an interest in any passive activity which produces income, the capital investor will be unable to utilize losses and tax credits generated by the start-up company. This puts the capital investor in no better position than the investor would be in if the start-up company operated as a C corporation and the investor was not entitled to take any deductions or credits with respect to its operations.

The capital investor's ability to deduct all deferred losses from a passive activity upon disposition of his interest in the passive activity generally will not provide an investor with any advantage that would not have been available had the company operated as a C corporation. Such deferred losses are first used to offset gain from disposition of the interest in the passive activity.[34] If gain from dis-

31. I.R.C. § 469(a)(1)(B) (1987). The federal income tax credit most likely to be available to a start-up technology company is the credit for increasing research activities under I.R.C. § 41 (1987). I.R.C. § 41(g) (1987) permits an individual taxpayer to use this credit only against income tax liability attributable to income of the business that engaged in the research activity. Under I.R.C. § 39 (1987), the research credit may be carried back up to three years or carried forward up to 15 years. These limitations are substantially unchanged from the limitations on utilization of the research credit prior to the 1986 Tax Act. In general, the limitations imposed specifically on the utilization of the research credit will be more restrictive than the passive activity loss limitation.

32. I.R.C. § 469(d)(2) (1987).

33. I.R.C. § 469(b) (1987).

34. I.R.C. § 469(g)(1)(A)(i) (1987).

position of an interest in a start-up company operated as a limited partnership exceeds the taxpayer's deferred loss, the excess gain taxable to the investor should be substantially the same as the amount of gain that would have been recognized by the investor upon a disposition of a comparable interest in the company had it operated as a C corporation.[35] Similarly, any deferred loss in excess of gain from disposition of an interest in a passive activity, which the investor may deduct in the year of such disposition, will be substantially similar in amount to the loss which such investor would incur upon disposition of a comparable interest in a company operated as a C corporation.

In many cases in which the company is operated as a C corporation, the investor will hold stock qualifying for ordinary loss treatment under I.R.C. Section 1244.[36] All or some portion of any loss incurred upon disposition of such stock in such a C corporation would be deductible against all types of income.[37]

A potential advantage of operating in limited partnership form is that, in spite of the passive activity loss limitation, an investor in a limited partnership eventually will be entitled to deduct losses allocated to him. It is not necessarily the case that a C corporation will eventually be able to deduct losses it incurs. This is due to the enactment of revised restrictions on a C corporation's ability to utilize its net operating loss carry-forward.[38]

The revised restrictions limit the availability of any net operating loss of the corporation incurred prior to the date of certain shifts of ownership of the corporation. Such a shift occurs if any group of shareholders, each of whom owns at least five percent of the stock of a C corporation at any relevant time, (or any group of such shareholders and all shareholders owning less than 5% of such stock) increases its share holdings by more than 50 percentage

35. The deferred loss reduced the taxpayer's basis in the activity. Assuming the same selling price for the interest in the activity, gain from sale of a limited partnership interest will exceed gain from sale of a C corporation interest by the amount of any basis reduction for passive activity losses. If the entire passive activity loss is deferred to the year of sale, it will reduce gain from sale by this same amount.

36. I.R.C. § 1244 (1987) treatment is available only to individuals with respect to stock issued to such individuals or to a partnership for cash or other property (excluding stock and securities) received from the holder of such stock by the corporation prior to its having in excess of $1,000,000 of paid-in capital. I.R.C. §§ 1244(a) and (c) (1987).

37. Ordinary loss treatment from I.R.C. § 1244 (1987) stock is limited to $100,000 per year for married individuals filing a joint return and to $50,000 per year for all other taxpayers, including a partnership investing in I.R.C. § 1244 (1987) stock.

38. I.R.C. § 382 (1987) as amended by the 1986 Tax Act, § 621.

points within a three-year period.[39] It is likely that a start-up high technology company will have one or more such shifts in ownership. The shifts cause the application of the restriction on the start-up's use of a prior net operating loss to apply.

It is typical for a start-up high technology company to have several rounds of financing and to issue securities convertible into stock. The effects of any new issuance of stock, of any conversion of convertible debt (or preferred stock with debt characteristics) and most reorganization transactions are taken into account in determining whether a shift in ownership has occurred. Also considered are the effects of purchases and sales among shareholders.[40]

A C corporation experiencing such a shift in ownership generally is permitted to deduct its prior net operating loss in any year only to the extent of a certain long-term tax-exempt rate applied to the value of the corporation immediately prior to the shift in ownership.[41] In many cases a start-up high technology company will have spent the proceeds of early rounds of financing (generating a net operating loss) and will be in financial difficulty when later financings cause shifts in ownership to occur. In such cases, very little of the net operating loss may be usable. If a C corporation does not continue its business for at least two years following a shift in ownership, its entire pre-shift net operating loss is disallowed.[42] As a result of this provision, a C corporation may be taxable on income that economically benefits a shareholder who was a shareholder when the corporation incurred a loss in a prior period. The shareholder is not able to offset the share of such income by the shareholder's share of such loss.

The passive activity loss limitation neutralizes the principal advantage that the limited partnership form had over the corporate form for start-up high technology companies during the early period of research and development expenses and losses from operations. The tax benefits and detriments to the capital investors from operating as a limited partnership or as a C corporation during this phase of the business enterprise will be comparable for most investors. However, there may be certain investors that would continue to receive a benefit from the operation of the start-up company as a limited partnership or in some other unincorporated form. For example, investors that are not subject to the passive loss limitation

39. I.R.C. § 382(g)(1) (1987).
40. I.R.C. § 382 (g)(2) (1987).
41. I.R.C. § 382(b) (1987).
42. I.R.C. § 382(c) (1987).

(such as a large C corporations) or investors that have substantial income from passive activities would still benefit.

There also may be certain companies that would benefit from operating as limited partnerships. An example is a company that would not be able to make effective use of carried forward net operating losses if operated as a corporation.

B. *Restrictions on Cash Method of Accounting*

Prior to the 1984 Tax Act, many start-up high technology companies operated in partnership form and used the cash method of accounting for federal income tax purposes. These companies would prepay research and experimental expenditures and other deductible business expenses in order to give the capital investors the tax benefit of the deduction for such payments as early as possible.

The 1984 Tax Act added subsection (i) to I.R.C. Section 461 which significantly limits a start-up company's ability to accelerate deductions for its investors by prepayment of expenses.[43] Most start-up high technology companies operated as limited partnerships are tax shelters subject to the restrictions of I.R.C. Section 461(i),[44] and, therefore, they will be permitted to deduct prepaid items only if the company receives the value of the services or property acquired by such prepayment or any other applicable economic performance not later than 90 days following the end of the taxable year in which prepayment occurs.[45]

The 1986 Tax Act has taken this restriction a step further. It prohibits certain business entities from using the cash method of accounting.[46] Most start-up companies operated as limited partnerships will be subject to this provision and will not be permitted to use the cash method of accounting or to deduct any prepayments.[47]

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43. The 1984 Tax Act § 91(a).

44. For such purposes "tax shelter" is defined to include any enterprise (other than a C corporation) that has offered interests for sale required to be registered with any federal or state agency regulating the sale of securities, any partnership allocating more than 35% of its losses during the taxable year to limited partners, and any partnership, plan or arrangement the principal purpose of which is tax avoidance or evasion. I.R.C. § 461(i)(3) (1987).

45. I.R.C. § 461(i)(2)(A) (1987). Prior to the enactment of I.R.C. § 461(i) (1987), case law permitted the deduction of up to one year of prepayments. *See* Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980).

46. I.R.C. § 448, added by the 1986 Tax Act § 801.

47. Subject to certain inapplicable exceptions, I.R.C. § 448 (1987) applies to C corporations and partnerships having a C corporation as a partner, if their average gross receipts for the prior three taxable years exceeds $5,000,000, and to any tax shelter, as defined in I.R.C. § 461(i)(3) (1987) (*see supra* note 44) without regard to gross receipts.

C. *Tax Shelter Registration and Penalty Provisions*

Many start-up high technology companies operated as limited partnerships, as well as their investors, will be subject to recently enacted provisions of the I.R.C. designed to improve compliance with the federal income tax laws. The provisions of principal concern are those requiring registration of tax shelters and those imposing penalties on understatements of tax liability attributable to tax motivated transactions. Other provisions include increased interest rates on deficiencies, daily compounding of interest, penalties for understatement of taxes due to overvaluation of property and application of fraud penalties to interest in addition to tax underpayment.

I.R.C. Section 6111 requires a tax shelter organizer to register the tax shelter with the Internal Revenue Service prior to selling any interests in the tax shelter. This section defines "tax shelter" as any investment (1) with respect to which any person could reasonably infer from the representations made in connection with the offering of interests in the investment for sale, that the tax shelter ratio for any investor as of the close of any of the first five years ending after the investment is offered may be greater than two to one, and (2) which is required to be registered under any federal or state securities law, which is exempt from registration under any federal or state securities law pursuant to a provision requiring the filing of notice, or with respect to which the aggregate amount offered exceeds $250,000 and there are expected to be five or more investors.[48]

"Tax shelter ratio" is defined as the ratio of the aggregate amount of deductions and 350 percent of the credits which are represented to be potentially allowable to any investor for a particular period to the cash (and adjusted basis of other property) contributed by the investor through the end of such period.[49] Computations of tax shelter ratio must utilize gross deductions without any reduction for any items of gross income reportable by the investor, unless the investment is expected to generate positive taxable income during each of its first five years.[50]

Many start-up high technology companies are not expected to generate taxable income during one or more of their first five years and will have sufficient gross deductions over the first five years of operations to come within the definition of "tax shelter." Penalties

48. I.R.C. § 6111(c)(1) (1987).
49. I.R.C. § 6111(c)(2) (1987).
50. Temporary Regulations § 301.6661-1T(A-6).

are assessed against the promoters of a company in certain instances: (1) for failure to register timely; (2) for failure to provide the tax shelter registration number to investors; and (3) for failure to maintain investor lists.[51] Investors will incur penalties if they fail to report this registration number on any federal income tax returns on which they claim any deduction, loss, credit, or other tax benefit or report any income from investment in a tax shelter.[52]

A twenty-five percent (25%) penalty for substantial understatement of income tax liability is imposed upon an individual taxpayer if the amount of the tax required to be shown on his return exceeds the tax actually shown on the return by more than the greater of 10% of the tax required to be shown or $5,000. The substantial understatement penalty is not imposed on any portion of an understatement attributable to an item if the taxpayer has substantial authority for its treatment of the item or discloses the relevant facts affecting the item's tax treatment, unless the item is attributable to a tax shelter.

With respect to an item attributable to a tax shelter, the penalty may be avoided only if the taxpayer has substantial authority for its treatment of the item *and* reasonably believes that the treatment of such item is more likely than not the proper treatment. For purposes of this penalty, the term "tax shelter" includes any partnership the principal purpose of which is the avoidance or evasion of federal income tax.[53]

The increased reporting and compliance burden imposed upon companies operated as limited partnerships and their investors, combined with the limited availability of deductions to such investors, will lead many high technology companies to avoid operating as limited partnerships during their start-up phases.

III. OPERATING AS A C CORPORATION AS THE BUSINESS MATURES

Maturing start-up high technology companies generally have operated as C corporations. Those companies that started out in this form have continued it, while many of the companies that began in other forms, including limited partnership form, have converted to the C corporation form. This is attributable in large part to the beneficial federal income tax treatment available to such a business enterprise from operating as a C corporation.

51. I.R.C. §§ 6707(a) and 6708 (1987).
52. I.R.C. § 6707(b) (1987).
53. I.R.C. § 6661 (1987).

Changes in the federal income tax laws enacted in the 1986 Tax Act and other recent tax legislation, have significantly diminished the tax advantage of operating as a C corporation at such times. In some instances it may be disadvantageous for such a business enterprise to operate as a C corporation. Many such business enterprises can be expected to operate or to continue to operate as limited partnerships during their maturing phases.

The principal federal income tax considerations to be taken into account in deciding the form of entity to be used by a high technology company as it begins to mature are discussed below.

A. *Corporate Tax Rates Exceeding Individual Tax Rates*

Start-up high technology companies that are profitable generally use their profits internally to maintain or expand their business operations. Owners generally do not receive cash distributions from such profitable business operations. Instead they are rewarded by increases in the value of their interest in the company as its business operations expand and its profitability increases. In the past this has caused start-up high technology companies to operate as corporations when they begin to generate positive taxable income.

The maximum federal income tax rate for corporations has generally been lower than the corresponding individual tax rate. Accordingly, operating as a corporation while generating positive taxable income usually reduced the tax cost on profits retained for business operations or expansion.

Prior to the 1986 Tax Act, the maximum marginal federal income tax rate for individuals was 50% and the maximum marginal federal income tax rate for C corporations was 46%.[54] The first $100,000 of a corporation's taxable income was subject to lower tax rates of 15% on the first $25,000 of taxable income, 18% on the second $25,000, 30% on the third $25,000 and 40% on the fourth $25,000. The benefit of these lower tax rates was phased out with a surcharge of 5% on taxable income in excess of $1,000,000 (but less than a $1,405,000).[55]

Because most start-up high technology companies are relatively risky investments, they generally require their capital investors to have sufficient net worth to be able to afford losing their capital investments in the company. Therefore, the company generally assumes that such capital investors are at or near the individual

54. Former I.R.C. §§ 1 and 11.

55. Former I.R.C. § 11(b).

maximum marginal federal income tax rate. The entrepreneurial founders of a successful start-up high technology company and the key employees of such a company who have any significant ownership in it can be expected to be at or near the highest individual federal income tax brackets when the company is operating profitably.[56]

The 1986 Tax Act has reversed the historical relationship between corporate tax rates and individual tax rates. Effective January 1, 1988, the maximum tax rate for individuals will be 28%. Effective July 1, 1987, the maximum tax rate for corporations is 34%.[57] The lower corporate tax brackets extend only through $75,000 of taxable income (instead of through $100,000 of taxable income under prior law). Additionally, the benefit of the lower corporate tax rates is recovered through the imposition of an additional 5% tax upon taxable income between $100,000 and $335,000 (instead of taxable income between $1,000,000 and $1,405,000 under prior law).[58]

The effect of this change in the tax law is best illustrated by an example. A corporation having $280,000 of taxable income in a taxable year governed by the corporate income tax rates adopted under the 1986 Tax Act will pay $92,450 in federal income taxes.[59] This is slightly in excess of 33% of the corporation's taxable income. If this amount of income were taxable to individual owners of the company, they would collectively pay less federal income taxes on such income, even if all of them were taxed on such income at the highest marginal rate for individuals. A number of such individuals' marginal federal income tax rates on such income taxable

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56. Under the 1986 federal income tax rate schedules, for married individuals filing jointly the 49% rate applied to taxable income between $118,050 and $175,250 and the 50% rate applied to taxable income in excess of $175,250, and for single taxpayers the 48% rate applied to taxable income between $59,670 and $88,270 and the 50% rate applied to taxable income in excess of $88,270. For 1987, the individual maximum marginal federal income tax rate (38.5%) applies to taxable income in excess of $90,000 for married individuals filing jointly ($54,000 for single individuals). For 1988, the 28% rate will apply to taxable income in excess of $29,750 for married individuals filing jointly ($17,850 for single individuals), and the 5% rate adjustment surcharge will begin at $71,900 of taxable income for married individuals filing jointly ($43,150 for single individuals).

57. I.R.C. §§ 1 and 11. The maximum marginal federal income tax rate for individuals will be 33%, and the maximum marginal federal income tax rate for corporations will be 39%, due to a 5% rate adjustment surcharge imposed upon individuals to phase out the 15% tax rate and to recover personal exemption deductions and imposed upon corporations to phase out the lower marginal rates on taxable income below $75,000. I.R.C. §§ 1(g) and 11(b) (1987).

58. I.R.C. § 11(b) (1987).

59. Calculated under I.R.C. § 11(b) (1987) as: (15%)($50,000) + (25%)($25,000) + (34%)($280,000−$75,000) + (5%)($280,000−$100,000) = $92,450.

to them would be 28% instead of 33%. This is because either their taxable income would be below the level at which the 5% surtax is imposed,[60] or their taxable income would be above the taxable income level at which the 5% surtax disappears.[61]

This differential between tax liability on such income when taxed at the corporate rates and the tax when taxed at the individual investor rates is in sharp contrast with the corresponding result under the federal income tax rates which were in effect prior to the enactment of the 1986 Tax Act. Using 1986 federal income tax rates, a corporation would pay $108,550 of federal income tax on $280,000 of taxable income (approximately 38.8%).[62] In 1986, single individuals with taxable income over $36,800 and married individuals filing joint returns with taxable income over $49,420 would have paid federal income taxes at the rate of 38% or higher on any additional income from the company if it were taxable to them individually.[63]

Under this tax rate structure having corporate rates higher than individual rates, the federal income taxes imposed upon a company's operations when it is operated in corporate form may exceed those imposed upon the owners of the company if the company is operated in limited partnership form. The consequences of this relative rate reversal under the 1986 Tax Act is that many companies will have more cash available for their operations and expansion if they operate as limited partnerships after they become profitable. Such a limited partnership would need to distribute less cash to its partners in order to provide them with the funds necessary to pay taxes incurred with respect to taxable income generated by the business, than a company operating in corporate form would pay in-federal income taxes. Because the federal income tax rates imposed upon individuals are relatively flat (the maximum average rate is 28% and many individual's marginal rates will be 28%), the deter-

60. For 1988, taxable income of $71,900 for married individuals filing jointly ($43,150 for single individuals).

61. For 1988, taxable income of $149,250 for married individuals filing jointly ($89,560 for single individuals) plus $10,920 for each personal exemption.

62. Calculated under former I.R.C. § 11(b) (1987) as: (15%)($25,000) + (18%)($25,000) + (30%)($25,000) + (40%)($25,000) + (46%)($280,000 − $100,000) = $108,550. This should not be used to make any comparison between the total tax liability under the 1986 tax rates and total tax liability under the rates established by the 1986 Tax Act, because taxable income has been redefined and many tax credits have been eliminated. The example is intended to show only the relative income taxes liabilities between operating in corporate form and operating in unincorporated form.

63. Former I.R.C. § 1 (1984), as adjusted for cost of living increases.

mination of the appropriate amount to distribute to the partners to pay their income taxes should be relatively straightforward.

B. *Revision of the Corporate Minimum Tax*

In addition to the relatively high federal income tax rate imposed upon C corporations, the 1986 Tax Act includes an alternative minimum tax for C corporations (replacing the corporate add-on minimum tax) that may increase the tax burden on many high technology companies operating as corporations.[64]

The tax preference item that will have the most significant effect upon such a corporation is 50% of the excess of the corporation's pre-tax income for financial reporting purposes (beginning in 1990, 75% of the excess of earnings and profits) over the corporation's alternative minimum taxable income computed without regard to such preference item.[65] Differences between the computation of book income and the computation of alternative minimum taxable income could result in a corporation paying alternative minimum taxes significantly in excess of its regular income tax liability.

C. *Income May Offset Passive Activity Losses of Investors*

An owner of a maturing technology company operated as a limited partnership may pay little or no additional taxes in a particular year as a result of being taxed on the income of the company. An owner would be in this position if he had losses from passive activities available in such year that he would not otherwise be able to deduct because of the limitation on the deductibility of losses from passive activities.[66] This could apply to an owner in the highest marginal federal income tax bracket.

A high technology company operated in limited partnership form is a passive activity for a capital investor holding limited partner interests.[67] Such an investor might have passive activity losses available in a given year, which he could deduct against income from the high technology company that he would otherwise be required to carry forward to a later year. Such losses may include losses generated by the high technology company in an earlier phase of its operations and losses generated by other passive activities of

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64. The Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. —, October 22, 1986.

65. I.R.C. § 56(f) (1987).

66. I.R.C. § 469. *See supra*, discussion under II.A.

67. I.R.C. § 469(h)(2) (1987).

the investor, whether incurred in such year or deferred from a prior year.[68] The passive activity losses which could offset such income would not be limited to losses generated by high technology companies, but would extend to losses from any passive activity, including real estate operations, equipment leasing operations, and any other business activities in which the individual is a passive investor.[69]

A start-up high technology company may operate as a limited partnership during its loss years, but eventually incorporate. Such a company may decide to defer incorporation for some period of time due to the limitation on the deductibility of losses from passive activities.

If any investor has had to carry forward losses generated by the start-up company because of such limitation, the company could benefit by continuing to operate as a limited partnership until it has generated income in an amount sufficient to permit the investor to deduct such carried-forward losses.

During this period the investor will incur no additional income tax liability. The income allocated to such an investor is offset by losses he otherwise would not be able to use. While continuing to operate as a limited partnership, the company pays no federal income tax. If the company incorporated prior to this time, the company would pay taxes on its income immediately and the investor would not be able to deduct the carried-forward losses until he disposed of his interest in the corporation or received income from some other passive activity.[70]

D. *Disposition of the Start-Up Company*

Most start-up high technology companies, whether or not they are successful, do not operate independently for an indefinite period of time. In many cases the assets or the operations of a start-up company are absorbed by or combined with those of another business enterprise. Many start-up high technology companies are structured to facilitate their disposition or combination with other business enterprises.

The form of organization selected by a start-up company during its maturing phase is in many cases designed to minimize the tax

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68. I.R.C. § 469(b) (1987).

69. I.R.C. § 469(d) (1987).

70. I.R.C. § 469(f) (1987). This assumes that the limited partnership is incorporated in a nontaxable transaction under I.R.C. § 351. The investor may deduct any carried forward passive activity losses against any gain he recognizes upon incorporation of the limited partnership. Dividends do not qualify as income from a passive activity so that these carried forward losses could not offset dividends paid by the corporation.

impact to the company and its investors in the event of any disposition of the company or its assets or of any combination with another business organization. Start-up high technology companies often have operated as corporations in order to have the greater flexibility and opportunity for tax advantage in such event provided through choices between taxable transactions and tax-free reorganizations.

Prior to the 1986 Tax Act, the tax consequences upon sale of the assets of a company or upon sale of the ownership interests in it, would not have varied materially based upon whether the company was operated as a limited partnership or as a corporation. However, the 1986 Tax Act has repealed the so-called *General Utilities* doctrine[71] so that there may now be a significant tax disadvantage to operating in corporate form if the start-up company is, or its assets are, sold to another business organization at a taxable gain.

Following the repeal of the *General Utilities* doctrine, the sale of the assets or ownership interests in a corporation will trigger tax liabilities for both the corporation and its owners. Only the owners are subject to tax liability when the company is operated as a limited partnership.[72]

Under former I.R.C. Section 337, a corporation selling assets could avoid tax at the entity level by adopting a plan of complete liquidation prior to the sale of its assets and completely distributing all assets of the corporation (including the proceeds of any sale) to shareholders within one year following the adoption of the plan of liquidation.[73] The shareholders of the liquidating corporation would report gain or loss in the amount of the difference between

71. A number of sections under Subchapter C of Chapter 1 of Subtitle A of the former I.R.C., including former I.R.C. §§ 333, 336 and 337, are generally regarded as codifications of the principles established by General Utilities & Operating Company v. Helvering, 296 U.S. 200 (1935).

72. The repeal of former I.R.C. §§ 333, 336 and 337 is generally effective for liquidating distributions made after July 31, 1986, unless the corporation is completely liquidated prior to January 1, 1987, or prior to January 1, 1988, pursuant to a plan of liquidation adopted prior to August 1, 1986. A transition rule provides that certain small corporations which completely liquidate prior to January 1, 1989, will be required to include in income from liquidation only ordinary gain or loss, short-term capital gain or loss, and gain or loss from disposition of installment obligations, and will not be taxable on long-term capital gain or loss or I.R.C. § 1231 gain or loss. A qualified corporation is any corporation in which the fair market value of all stock is less than $10,000,000 (although the benefit of the transition rule phases out for corporations having fair market values between $5,000,000 and $10,000,000) and in which, on August 1, 1986, and at all times thereafter prior to complete liquidation, ten or fewer individuals, estates, or qualified trusts hold more than 50% (by value) of the corporation's stock. I.R.C. § 633(d) (1987).

73. Former I.R.C. § 337(a) (1984).

the fair market value of assets received on liquidation and the basis in their stock. The shareholders would be subject to tax liability,[74] but the corporation itself would not be subject to tax on gain from the sale of its assets.[75] The company purchasing the assets would get a new basis in such assets for depreciation, amortization and disposition purposes equal to the price paid for such assets.[76]

Since a limited partnership is a pass through entity which is not subject to taxation, the tax consequences of selling the assets of a partnership and liquidating it would be comparable to this treatment of corporations under former I.R.C. Section 337.[77] As a result of the repeal of former I.R.C. Section 337, a corporation selling assets and liquidating will recognize gain or loss on the sale of assets. The corporation will pay taxes on any gain from such a transaction.[78]

The corporation cannot avoid the tax liability that it would incur upon sale of its assets by distributing those assets to its shareholders and having the shareholders sell the assets.[79] The 1986 Tax Act also repealed former I.R.C. Section 336 which provided that a corporation would not recognize gain or loss on distribution of its assets to shareholders in complete liquidation of the corporation.[80] As a result of this repeal, a corporation will be obligated to report gain or loss in the amount of the difference between the fair market value of its assets distributed and the corporation's basis in such assets upon a liquidating distribution of such assets to shareholders.

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74. I.R.C. § 331(a) (1984).

75. A corporation liquidating under former I.R.C. § 337 would recognize income on sale of inventory unless sold to one person in one transaction (former I.R.C. § 337(b)), on sale of certain installment obligations (former I.R.C. § 337(b)(1)), under the tax benefit rule on sale of property previously expensed (S.E. Evans, Inc. v. United States, 317 F.Supp. 423 (W.D. Ark 1970) and Commissioner v. D.B. Anders, 414 F.2d 1283 (10th Cir. 1969), *cert. denied* 396 U.S. 958 (1969)), and on sale of depreciation recapture property (Franklin Clayton, 52 T.C. 911 (1969)). The Internal Revenue Service has recently ruled that gain on sale of technology does not result in recapture under the tax benefit rule of research and experimental expenditures incurred to produce the technology. Rev. Rul. 85-186, 1985-2 C.B. 84.

76. I.R.C. § 1012 (1984).

77. The gain (loss) on sale of the assets allocated by the limited partnership to a partner would increase (decrease) his basis in his partnershp interest (I.R.C. § 705) and the subsequent distribution of cash to the partner following the sale of assets would cause the partner to recognize gain (or loss) in the amount of the difference between the cash received (fair market value of all property received) and the adjusted basis in his partnership interest (I.R.C. § 731).

78. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. —, October 22, 1986.

79. This technique was used prior to the enactment of former I.R.C. § 337, but had its difficulties in practice. *See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

80. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), 100 Stat. —, October 22, 1986.

This is in addition to the shareholders' tax consequences from gain or loss in the amount of the difference between the fair market value of assets received and basis in stock surrendered on such liquidation.[81]

If the owners of a business operating in corporate form sell their stock (instead of the corporation selling assets), they will be taxed on the difference between the amount received and the basis of their stock.[82] The sale of such stock in and of itself, will not cause the corporation to report any taxable gain or loss. However, if the value of the corporation's assets substantially exceeds the corporation's basis in such assets, the corporation will continue to have a contingent tax liability associated with such assets in the amount of the difference between such fair market value and the corporation's basis in such assets. The acquiring shareholder does not have the benefit of the purchase price paid for the interest in the company for purposes of determining any depreciation or amortization deductions with respect to the assets of the acquired company or for purposes of determining gain or loss on disposition of any such assets.

A corporation acquiring stock in another corporation can increase the basis of assets in the acquired corporation by making an election under I.R.C. Section 338. Prior to the 1986 Tax Act, making such an election would have increased the corporation's basis in the assets of the acquired corporation to their fair market value, without requiring the acquired corporation to recognize gain attributable to such increase.[83] The repeal of the *General Utilities* doctrine will require the acquired corporation to recognize such gain on any such election under I.R.C. Section 338 and to incur federal income tax liability with respect to such gain in order to obtain an increased basis in such assets.

Liquidation of a company operated as a corporation by those acquiring its stock would require the acquired corporation to recognize gain on such liquidation as described above. An exception applies to certain liquidations qualifying under I.R.C. Section 337.[84] If the liquidation does qualify for nonrecognition treatment under this limited exception, the acquiring corporation will not get an increased basis in the assets of the acquired corporation upon such

81. Under I.R.C. § 331 (1984).

82. I.R.C. § 1001 (1984).

83. Due to the reference to former I.R.C. § 337 in I.R.C. § 338(a)(1) (1986).

84. I.R.C. § 336 (1987).

liquidation.[85]

There may still be tax advantages available upon disposition of a start-up company operated as a corporation if its assets or ownership interests are exchanged for ownership interests in another business organization in a tax-free reorganization.[86] Generally, neither the shareholders of the acquired corporation[87] nor any participating corporation[88] recognizes gain or loss as the result of a reorganization.

However, the 1986 Tax Act has made reorganizations less attractive to acquiring corporations. The acquiring corporation's basis in the assets of the acquired corporation will be the same as it was prior to the reorganization.[89] If the fair market value of such assets is substantially greater, the acquired corporation will not get the benefit of an increased basis and will take on a contingent tax liability. As a result of the repeal of the *General Utilities* doctrine, this cannot readily be avoided. Enactment of the limitation on deductibility of net operating losses following certain changes in ownership also has diminished the attractiveness of a reorganization to the acquiring company.[90]

E. *Diminished Attractiveness of Incentive Stock Options*

Many start-up high technology companies have used incentive stock options to compensate their key employees since the 1981 Tax Act[91] made their issuance available.[92] By compensating employees with incentive stock options, a start-up company can reduce to some extent the cash compensation it pays its employees. The start-up company thereby preserves some of its limited cash resources which would otherwise be necessary to compensate employees. Incentive stock options may be granted only by corporations. This has provided an additional reason for operating start-up high technology companies as corporations.[93]

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85. I.R.C. § 334(b) (1984).
86. *See* I.R.C. § 368 (1986).
87. I.R.C. §§ 354 - 355 (1984).
88. I.R.C. § 361 (1984).
89. I.R.C. § 362 (1984).
90. *See supra* discussion under II.A.
91. References herein to the "1981 Tax Act" are to The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) (H.R. 4242, 97th Congress).
92. *See* I.R.C. § 422A (1984).
93. In some cases a start-up company operated in limited partnership form has a corporate general partner that issues incentive stock options. This structure provides the incentive stock option benefit to employees, but, because the exercise of such options dilutes only the corporate general partner's interest in the company (generally affecting the founding entre-

The preferential federal income tax treatment given to incentive stock options enhances their value to the employees receiving them. An employee who is granted an incentive stock option has no taxable income upon its grant or its exercise.[94] Unless the employee sells the stock received upon the exercise of an incentive stock option within two years following the grant or within one year following exercise, any gain on sale is taxable as long-term capital gain.[95]

The tax advantage of long-term capital gain treatment was significant when 60% of net long-term capital gains was excluded from taxable income. The repeal of preferential tax treatment for capital gains by the 1986 Tax Act eliminated the principal advantage to the employee from accepting incentive stock options in lieu of other forms of compensation.

The 1984 Tax Act diminished an employee's ability to defer federal income taxes using incentive stock options to some extent by making the difference between fair market value of the stock at time of exercise and the exercise price a tax preference item for purposes of the alternative minimum tax.[96] Under the 1986 Tax Act, the alternative minimum tax rate for individuals has been increased to 21%.[97] More individuals are likely to be subject to the alternative minimum tax than under prior law because this rate is not much lower than the generally applicable federal income tax rate of 28%. Certain employees receiving incentive stock options may pay alternative minimum taxes upon exercise of the options in addition to the regular federal income tax at ordinary income rates upon disposition of the stock. This would place a heavier tax burden on employees receiving incentive stock options than would apply to other forms of deferred incentive compensation.[98]

Incentive stock options provide a federal income tax disadvantage to the granting corporation because the corporation receives no deduction for their compensatory value.[99] Under other forms of in-

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preneurs) and does not dilute the limited partner interests (generally held by capital investors), the use of this structure may cause distortions among the ownership interests of the capital investors, the entrepreneurs, and the key employees.

94. I.R.C. § 421(a)(1) (1984).

95. I.R.C. § 422A(a); Temp. Treas. Reg. § 14a.422A-1(A-2) (1986).

96. I.R.C. § 57(a)(10) (1986).

97. I.R.C. § 55(b)(1)(A) (1987).

98. For example, a stock appreciation right could be designed to provide an employee with the same economic benefits and tax consequences upon exercise of the right as the employee would receive upon sale of stock acquired under an incentive stock option, but neither grant nor exercise of the stock appreciation right would generate any tax preference item for the employee.

99. I.R.C. § 421(a)(2) (1984).

centive compensation, the company will receive the benefit of such a deduction.[100]

Under APB Opinion No. 25, currently in effect, a company receives an advantage for financial accounting purposes, by issuing incentive stock options rather than other forms of incentive compensation. The company's earnings are not charged with any amount upon grant or exercise of incentive stock options. However, the Financial Accounting Standards Board has proposed the revision of this current accounting practice to provide for a charge against the company's earnings based upon the benefit received by employees from incentive stock options.

As a result of the changes in the federal income tax laws and the expected changes in financial accounting standards, many companies will use nonstatutory stock options, stock appreciation rights, and other forms of incentive compensation, rather than incentive stock options. All of these forms of incentive compensation other than incentive stock options are as readily available under the limited partnership form of entity as they are under the corporate form. The availability of incentive stock options is no longer a significant reason for incorporating.

F. *Qualified Retirement Plans and Other Employee Benefits*

Prior to the 1982 Tax Act,[101] the owner-employees of a company operated in limited partnership form were at a significant disadvantage relative to owner-employees of companies operated in corporate form with respect to the availability of and permissible benefits under qualified pension and profit-sharing plans and various other types of employee benefit programs. The 1982 Tax Act, together with technical corrections made by the 1984 Tax Act and the 1986 Tax Act, has eliminated virtually all distinctions between the qualified pension and profit-sharing plans that may be provided by a company operating in corporate form and those that may be provided by a company operating in limited partnership form.

The 1986 Tax Act has diminished the distinctions between operating as a corporation and operating as a limited partnership with respect to other employee benefits. For example, an owner-employee of a limited partnership is now permitted to deduct 25% of

100. For example, upon an employee's exercise of a nonstatutory stock option, the company is entitled to deduct the difference between the fair market value of the stock purchased and the exercise price.

101. References to the "1982 Tax Act" are to the Tax Equity and Fiscal Responsibility Tax Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982) (H.R. 4961, 97th Congress).

his medical insurance coverage.[102]

Additionally, a uniform set of nondiscrimination rules for coverage and benefits under certain statutory employee benefit plans has been established. In general, these rules do not treat highly compensated employees of a company operating in limited partnership form less favorably than the highly compensated employees of a company operating in corporate form.[103]

Increased availability of employee benefits should no longer be a significant reason for operating in corporate form, because the major distinctions between the employee benefits available through a company operated in corporate form and those available through a company operated as a limited partnership have been eliminated.

IV. CONCLUSIONS

Under current federal income tax laws, most start-up high technology companies intending to eventually operate as corporations should not begin their operations as limited partnerships. In most cases, there will be little federal income tax advantage available to investors from operating as a limited partnership during early loss years. This is primarily due to the newly enacted passive activity loss limitation as well as the recent changes in permissible accounting methods.

In most cases, federal income tax benefits derived from operating initially as a limited partnership will be outweighed by the expense and effort involved in converting from limited partnership form to corporate form and by the potential expense and effort that would be required of the company in the event it is audited by the Internal Revenue Service. Due to increased scrutiny of entities commonly used for tax avoidance purposes, an audit is more likely to occur if the company operates as a limited partnership.

In certain situations, it will be advantageous for a company to operate in limited partnership form prior to incorporating. These situations include those in which the company expects to generate a significant tax loss in its early operations and either has investors who, because of their personal tax situations, can utilize such losses currently or expect to have a series of capital financings or to use convertible debt in its financings. Successive capital financings or conversion of debt could cause the early year losses to become unusable by the company under the net operating loss carry-for-

102. I.R.C. § 162(m) (1987).
103. I.R.C. § 89 (1987).

ward restrictions if operated in corporate form. Companies will need to analyze the personal income tax situations of potential investors and to forecast the amounts, structure and timing of capital financings in order to determine whether the factors recommending early operations as a limited partnership are present.

Start-up companies which do operate as limited partnerships for some period of time and then incorporate need to analyze more carefully the appropriate time for changing from limited partnership form to corporate form. Under prior law, such companies would incorporate when they began to generate positive taxable income. Because of the passive activity loss limitation, it may now be beneficial to the investors in the company to continue as a limited partnership for some period of time after it begins to generate positive taxable income.

If possible, the company should attempt to determine the amount of losses generated that its investors have had to defer due to the passive activity loss limitation. The company should then continue to operate as a limited partnership until it generates sufficient taxable income to offset the substantial part of these deferred losses.

Although start-up companies that intend to eventually operate as corporations should not bother with starting out as limited partnerships, many start-up companies should operate as limited partnerships throughout their lives without ever incorporating. The federal income tax advantages of operating in corporate form in the maturing phase of a start-up company's life have been substantially eliminated.

Two distinct disadvantages to operating in corporate form at that time — the excess of the corporate income tax rates over individual income tax rates and the repeal of the *General Utilities* doctrine — make the limited partnership form the preferable form from a federal income tax standpoint for most start-up companies.

Because corporate tax rates will exceed individual tax rates, most successful companies that continue their operations will be better off operating in limited partnership form and making distributions to partners sufficient to permit the partners to pay their individual income taxes than the companies would be operating in corporate form and paying the corporate taxes. Companies operated as limited partnerships also will be able to sell their operations or assets without triggering tax liabilities at both the individual investor and the entity levels. The tax liabilities that may be incurred upon the disposition of a start-up company operated in corporate form or of its assets should reduce the value of such a company in the merger and acquisition marketplace. For these reasons, many start-up high technology companies should operate throughout their lives as limited partnerships.

If the current federal income tax laws remain in place, it can be expected that many start-up high technology companies will be formed as limited partnerships and will continue to operate as limited partnerships. However, Congress may reduce or eliminate the federal income tax advantages of the limited partnership form for such companies.

A report to the President published by the United States Treasury Department in November, 1984, proposed various revisions to the former I.R.C.. These revisions eventually led to the enactment of the 1986 Tax Act. The Report included a proposal that limited partnerships with more than 35 limited partners be taxed as corporations.[104] This provision was not included in the 1986 Tax Act, as ultimately enacted, but the issue is far from resolved.

On June 9, 1986, the House Subcommittee on Select Revenue Measures, chaired by Representative Charles B. Rangel,[105] began the first in a series of hearings designed to study the current tax law treatment of pass-through entities. On the first day of such hearings, J. Roger Mentz, Assistant Secretary of the Treasury for Tax Policy, testified that publicly traded limited partnerships should be taxed as corporations.

Assistant Secretary Mentz testified that if the rules for publicly traded limited partnerships are not changed soon, businesses will disincorporate in order to take advantage of the provisions under the 1986 Tax Act benefiting profitable companies operating as limited partnerships and their investors. He expressed concerns regarding the Internal Revenue Service's ability to audit large limited partnerships and to assure their compliance with the federal income tax laws.[106]

No one can be certain as to the federal income tax treatment that will ultimately apply to large limited partnerships. If a significant number of profitable corporations disincorporate and more start-up companies begin to use the limited partnership form more

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104. Legislation incorporating these proposals was introduced in the House of Representatives on February 7, 1985, as H.R. 1040, 99th Congress.

105. Congressman Rangel was the principal sponsor of H.R. 1040, 99th Congress.

106. *Issues Relating to Passthrough Entities: Hearings on H.R. 1658 Before the Committee on Ways and Means*, 99th Cong., 2nd Sess. 99-95 (1986) (statement of J. Roger Mentz, Assistant Secretary of the Treasury for Tax Policy).

often, it can be expected that Congress will perceive a reduction in revenues to the United States Treasury and will take some legislative action. In the meantime, there are significant federal income tax advantages to operating a business in limited partnership form. A start-up high technology company should give due consideration to these tax consequences in selecting its form of entity.