FEDERAL TAX CONSIDERATION IN CHOICE OF BUSINESS ENTITY

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I. INTRODUCTION

This chapter of the Practice Manual provides an overview of some of the key federal income tax aspects of choosing the form of entity in which to operate for-profit business and investment ventures under West Virginia law. The exclusive focus is on the following four principal types of business entitles in West Virginia: corporations, general partnerships, limited partnerships, and limited liability companies

For these entities there are three federal income classifications: associations taxable as corporations, partnerships, or disregarded entities. For corporations, there are two distinct federal income tax regimes: C corporations and S corporations. Federal income tax classification of an entity is not governed by state law characterization of the entity. Generally, under the classification regulations, a partnership or limited liability company with two or more members is taxed as a partnership under the default classification unless it elects to be taxable as a corporation. A limited liability company with only one member is treated as a disregarded entity unless it elects to be taxable as a corporation. In general, a West Virginia corporation will be taxed under federal law as a taxable (or subchapter C) corporation, unless it is eligible to and elects special tax treatment as a subchapter S corporation. However, an S corporation is identical to a C corporation for state law purposes.

These materials outline broad tax treatment and planning aspects of the three relevant federal income tax regimes: C corporation, S corporation and partnership. Comparing and contrasting different types of entities, under both federal tax and West Virginia law, provides groundwork for the lawyers' role of allowing a client to consider thoroughly the choice of entity in business and investment planning.

The following chart assumes that a general partnership, limited partnership and limited liability company is classified as either a partnership or a disregarded entity for federal tax purposes and provides an overview of some general federal income tax consequences from choosing a form of business activity:

CONSIDERATION	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP LTD. PARTNERSHIP AND LTD. LIABILITY CO.
Maximum number of owners	No limit.	Number of shareholders may not exceed 75.	"Limited" by publicly traded partnership rules.
Trust may be an owner	Yes.	Limited types of trusts may be shareholders.	Yes.
Corporation may be an owner	Yes.	No. Only individuals, estates, certain trusts, and certain tax-exempt organizations may be shareholders.	Yes.
Limited Liability Company may be an owner	Yes.	No, unless the LLC is a disregarded entity. Only individuals, estates, certain trusts, and certain tax-exempt organizations may be shareholders.	Yes.
Partnership may be an owner	Yes.	No. Only individuals, estates and certain trusts may be shareholders.	Yes.
Separate taxable entity	Yes.	Not normally except for WVBFT and "sting taxes."	No. (Except WVBFT)
Taxation of income	Taxed to corporation at § 11 rates. Shareholder taxed upon distribution of dividends.	Directly to shareholders at their rates. If there is "built-in gain" or excess passive income, the S corporation is taxed.	Directly to partners or members at their rates.

CONSIDERATION	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP LTD. PARTNERSHIP AND LTD. LIABILITY CO.
Contribution of property in exchange of ownership interest	No gain or loss recognized if the transferors control the company after the exchange. Possible exception if contributed property is subject to debt.	No gain or loss recognized if the transferors control the company after the exchange. Possible exception if contributed property is subject to debt.	No gain or loss recognized unless the contributed property is subject to debt and the debt is "deflected."
Contribution of services in exchange for ownership interest	Taxable.	Taxable.	Taxable. Possible exception if ownership interest is only a "profits interest."
Special allocation of income or losses to partners or shareholders	No.	No.	Yes, if has substantial economic effect.
Distribution to owner	Any built-in gain in distributed property taxable to the entity. Additional gain to shareholder upon receipt.	Distribution of appreciated property results in gain at shareholder level but shareholder gets basis increase.	No gain or loss recognized on distribution of property (other than money in excess of basis) until partner disposes of property.
Character of income and loss	Not applicable.	Character is passed through from entity.	Character is passed through from entity.
Treatment of liabilities with regard to basis	Decrease in basis upon corporate assumption for liability.	No increase of basis for share of entity liabilities.	Increase in basis for share of liabilities; decrease in share of liabilities treated as a cash distribution.

CONSIDERATION	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP LTD. PARTNERSHIP AND LTD. LIABILITY CO.
Deduction of losses on owner's tax returns	No. Deductible against corporate income. NOLs generally can be carried back 2 years and carried forward 20 years.	Yes. Deductible by shareholders to the extent of basis in stock and loans from shareholder to corporation. Deductibility may be limited by passive loss and at-risk rules.	Yes. Deductible by partners or members to extent of basis in partnership interest. A partner's share of debt is reflected in basis. Deductibility may be limited by passive loss and at-risk rules.
Liquidation	Corporation and shareholders generally recognize gain and loss.	Corporation recognizes gain or loss which is taxed to shareholder and reflected in basis.	Generally no gain or loss recognized. Gain or loss may be recognized for certain non-pro rata distributions or money in excess of basis.
IRS election required	None.	Yes.	None.
Federal tax return	Form 1120	Form 1120-S	Form 1065 or schedule C to Form 1040 if disregarded

II. REGULAR TAXABLE CORPORATIONS

For state law purposes a corporation is a separate legal entity that exists when properly executed articles of incorporation are issued by the West Virginia Secretary of State. A corporation is treated the same for state law purposes regardless of whether it is a taxable corporation or a subchapter S corporation. These materials address rules for operating and liquidating taxable corporations.

In many typical situations, a corporation can be formed tax-free under Code § 351. However, special tax concerns are present when (1) stock is received for services

(Code § 351(d)(1)), (2) appreciated property is conveyed to the corporation by a non-controlling shareholder outside the context of the original funding of the corporation (Code § 351(a) (control requirement)), (3) the corporation is funded in part or whole with marketable securities (§ 351(e)(1)) or nonqualified preferred stock (§ 351(g)), or (4) contributed property is subject to liability in excess of basis (Code § 357(c)). While it is often possible to plan effectively for the tax free formation of a corporation, the most difficulty relates to operating and liquidating the corporation.

For federal income tax purposes (and for West Virginia income tax purposes), a corporation that has not effectively elected subchapter S corporation status is generally a separate taxpaying entity. Thus, the subchapter C corporation files its own tax return and pays taxes on its taxable income at the separate corporate rates. Any money or other property that the corporation distributes to its shareholders or employees is independently taxable to them.

For example, if a C corporation earns taxable income in a year of $1,000,000, it pays federal income taxes of about $340,000 (assuming a 34% marginal tax rate) on its federal corporate tax return. If it then declares a dividend of the remaining $660,000 to its shareholders, they will also take that amount into taxable income, at ordinary income rates in the case of most dividends, and pay federal tax of about $254,760 (assuming a 38.6% marginal rate). Thus, a total of about $600,000, or 60%, of the initial $1,000,000 will have been paid in federal income taxes by the corporation and its shareholders. By comparison, the same $1 million earned by a "pass-through" entity would have resulted in approximately $386,000 of tax liability (assuming the same 38.6% marginal rate for individuals), or a savings of over $200,000 for that year.

Similarly, assume two shareholders form a C corporation, one shareholder contributes land and a building worth $1 million (but only $50,000 in tax basis) and the other shareholder contributes $1 million in cash. If one year later the shareholders desire to unwind the deal and liquidate the corporation, a huge tax problem ensues. The corporation owes about $323,000 of corporate income tax on the $950,000 "gain" on distributing the land. The shareholder who contributed the land and building will also recognize a second layer of gain when she receives her property back.

The "double tax" consequences are perhaps most extreme in the sell-out context. A buyer of a C corporation's business often prefers to buy assets for tax and other reasons. If the seller sells the C corporation's assets, the corporation recognizes gain on the difference of the amount realized over the corporation's basis in the assets triggering corporate tax. The subsequent liquidation of the corporation (that get cash into the shareholders' hands) is another taxable event for the shareholder.

In addition to the double tax phenomenon, corporations are subject to additional tax and accounting rules that do not apply to pass-through entities. For example, corporations can be treated as "personal service corporations" or "personal holding companies" and can be subject to the accumulated earnings tax and the corporate alternative minimum tax. For these and other reasons, regular "C" corporation status is often not desirable.

III. SUBCHAPTER S CORPORATIONS

A. GENERAL INTRODUCTION

A subchapter S corporation is a pass-through entity taxed in many ways like a partnership, but it is a corporation for state-law purposes. The election to be treated as an S corporation is wholly separate from the requirement that the S corporation comply with all state law requirements. That is, it also must have articles of incorporation, by-laws, minutes and observe other corporate formalities like any other corporation.

B. TAX TREATMENT

1. General.

A subchapter S corporation passes its items of income, loss and deduction through to its shareholders. Generally, the S corporation is not subject to a corporate level tax, accumulated earnings tax or the personal holding company tax. However, similar organizational issues respecting Code § 351 apply with respect to conveying property to an S corporation as discussed in connection with C corporations. Moreover, as discussed below, it may be subject to a tax on excess net passive income and built-in gains if the S corporation is a former "C" corporation.

2. Basis for Stock and Debt.

An S corporation shareholder's initial basis in her stock is based on its cost or the amount contributed to the capital of the corporation in exchange for the stock. Stock basis for each shareholder is increased by her pro rata share of each item of income. A shareholder's basis is reduced by distributions from the corporation that are not included in income, separately stated loss and deduction items, nonseparately computed losses, corporate expenses not deductible in computing taxable income and not properly chargeable to a capital account, and the amount of shareholder's depletion deduction to the extent it does not exceed that shareholder's proportionate share of the property's adjusted basis. However, stock basis cannot be reduced below zero.

If a shareholder makes a loan to an S corporation, her basis in that loan will be its face amount. Principal payments made on the loan by the corporation operate to reduce the shareholder's basis in that loan. If the shareholder's basis in her stock is zero, loan basis can be reduced by loss and deduction items. Likewise, subsequent increases in earnings will operate first to increase the basis in shareholder loans, then increase the basis in stock. However, shareholders do not obtain basis for guaranteeing corporate debt. See *Estate of Leavitt v. Commissioner*, 875 F.2d 420 (4th Cir. 1989).

C. QUALIFICATION AND ELECTION OF S CORPORATION STATUS.

1. General Rules of Eligibility.

An S corporation is a small business corporation which meets certain criteria and has made an election under § 1362(a), on IRS Form 2553. Corporations eligible to make the S election must meet the following criteria under § 1361(b): (1) be a domestic corporation; (2) have no more than seventy-five shareholders; (3) have shareholders who must be individuals, estates, certain trusts, or certain tax-exempt entities; (4) cannot have nonresident alien shareholders; (5) have no more than one class of stock; and (6) not be an ineligible corporation, as defined in § 1361(b)(2).

2. Electing S Corporation Status.

Only those eligible corporations which actually file a timely election on Form 2553 will be treated as S corporations. The election must be timely filed and all of the corporation's shareholders must consent to the election. Strict compliance is required, and extensions cannot be obtained. A timely filed election is effective for the taxable year for which it was made and succeeding tax years unless terminated or revoked. The election does not need to be renewed annually.

If the election is to be effective for the current tax year, it must be made on or before the fifteenth day of the third month of that tax year. If made after this date, the corporation will be treated as an S corporation beginning with the next tax year. If the corporation's taxable year is less than two months and fifteen days, the election can be filed within two months and fifteen days of the beginning of the first tax year. The Form 2553 should be photocopied and the original forwarded to the Internal Revenue Service by registered or certified mail, return receipt requested.

D. QUALIFIED SUBCHAPTER S SUBSIDIARY.

Subchapter S corporations may now own up to 100% of the stock of a subsidiary corporation. Prior law had prohibited S corporations from owning more than 80% of another corporation. See, Code §1361(b)(2)(A) prior to December 31, 1996. Additionally, the parent S corporation may now may an election to treat certain qualified subsidiaries as qualified subchapter S subsidiary ("Qsub") under Code §1361(b)(3). A Qsub is any domestic corporation which is not an ineligible corporation if the parent S corporation owns 100% of the stock of such corporation and makes an election of Form 8869. Code § 1361(b)(3)(B). Such an election is viewed as a liquidation of Qsub under Treas. Reg. §1.1361-4(a)(2). Additionally, the timing of making successive Qsub election may have a substantial impact on whether the liquidation will be treated as tax free. See, Treas. Reg. §1.1361-5(b). For Federal income tax purposes, upon election by the parent S corporation to treat a subsidiary as a Qsub, the Qsub will be a disregarded entity for federal income tax purposes, and all assets, liabilities, and items of income are treated as assets, liabilities, and income of the parent S corporation. See, discussion below concerning employment tax treatment of disregarded entities. If a corporation ceases to be a qualified subsidiary, such corporation shall be treated as a new corporation formed immediately prior to such disqualifying event. Upon termination of Qsub status, the subsidiary may not elect Qsub status or subchapter S status for five years after the date of such termination under Code §1361(b)(3). But see, Treas. Reg. §1.1361-5(c) concerning election after Qsub termination. The IRS has provided detailed regulations on the treatment and operation of the Qsubs. See, Treas. Reg. §§1.1361-2 through -6.

E. TERMINATION OF S CORPORATION STATUS.

As mentioned, the S corporation election does not need to be made annually, and continues in effect as long as the corporation remains in existence, even if shareholders leave or join the corporation. However, S corporation status may be terminated under § 1362(d), which termination may be either inadvertent or by voluntary revocation.

1. Voluntary Revocations.

An S corporation's status can be revoked by shareholders who own more than 50% of the corporation's stock, including nonvoting stock, under § 1362(d)(1). Such revocation is accomplished by the corporation filing a statement with the Internal Revenue Service Center where the S election was filed, and the statement should include the information set forth in Treas. Reg. § 1.1362-6. Of course, any single shareholder can cause termination by breaching eligibility rules, for example, by transferring her stock to an ineligible shareholder (like another corporation or partnership).

Revocation of an election has a prospective effective date, and elections cannot be revoked retroactively. However, if revocation is made within the first two months and fifteen days of the corporation's tax year, the revocation will relate back to the beginning of that year. If revocation is made after this initial period, it is only effective beginning with the next year, unless pursuant to § 1362(d)(1)(D) the revocation specifies a prospective effective date occurring during the tax year. A revocation can be rescinded at any time prior to its effective date, following the procedural requirements for rescission set forth in Treas. Reg. § 1.1362-6(a)(4).

2. Inadvertent Invalid Elections or Terminations.

As mentioned previously, an S corporation must meet certain requirements to qualify to elect S corporation status. If the corporation no longer meets these eligibility requirements, § 1362(d) causes S corporation status to terminate on the date the corporation ceases to qualify as an S corporation. Such terminations are prospective only.

In the event that an election is invalid or in the event the election is terminated because the corporation ceases to meet the requirements of a small business corporation, it is possible to obtain a waiver of such inadvertent invalid election or termination from the Internal Revenue Service if the requirements of § 1362(f) and the procedures of Treas. Reg. § 1.1362-4(a) are met. This generally requires that the terminating event be inadvertent in the view of the Internal Revenue Service, there is a timely correction of the event causing termination, and there is an agreement by the corporation and shareholders to make any adjustments that may be required by the Internal Revenue Service.

3. Excessive Passive Investment Income.

An S corporation's election will terminate if it has C corporation earnings and profits, and more than 25% of its gross receipts are from passive investment income for any three consecutive tax years. Code § 1362(d)(3). C corporations with accumulated earnings and profits that make an S election and S corporations that acquire C corporations with accumulated earnings and profit, are at risk, but planning options may be available to deal with the excess passive investment income problem.

4. Effects of Revocation or Termination of S Corporation Status.

The year in which the termination of S corporation status occurs is referred to as the S termination year. This S termination year consists of a short S year and a short C year. The short S year ends on the day before the occurrence of the terminating event and the short C year begins on the date of the terminating event. The short S year is not counted as a separate taxable year for carrybacks and carryforwards. § 1362(e)(6)(B).

Income and loss items for the S termination year are generally determined for the entire year and then allocated on a daily basis. § 1362(e)(2). However, this pro rata allocation rule will not apply if an acquiring corporation purchasing the S corporation makes a § 338 election. Furthermore, the pro rata allocation rule does not apply if 50% or more of the S corporation's stock changes hands during the S termination year. If this is the case, the closing of the books method is required, whereby the year is divided based upon the actual income or loss for the specific periods.

The termination of status as an S corporation has numerous other effects not discussed here, including the disallowance of losses, effect on previously taxed income, investment credits, recapture and estimated taxes of the resulting C corporation.

5. Re-election After Termination.

When an S corporation status is terminated either by voluntary revocation or inadvertently, S corporation status cannot be reelected until its fifth year after the tax year in which the termination occurred. It is possible, upon request, that the Internal Revenue Service will grant a consent to reelect under § 1362(g), before this waiting period has passed. This five-year waiting period includes the taxable year for which the termination or revocation is effective and the next four taxable years. Electing after termination is different from an invalid election, in which case, § 1362(g) does not apply and does not prevent the S corporation from electing S corporation status the following year. PLR 8925077. This is also the case if the S election was revoked before it became effective. PLR 8842007 and Treas. Reg. § 1.1362-5.

The five-year restriction on reelecting after termination also applies to "successor corporations." Former Reg. § 1.1372-5(b) provides the definition for a successor corporation. Generally, a successor corporation is one in which not more than 50% of the stock ownership, whether direct or indirect, has changed since the effective date of the termination of the S corporation status.

F. BUILT-IN GAIN TAX UNDER § 1374

1. The Tax Reform Act of 1986.

One effect of the Tax Reform Act of 1986 was to cause recognition of gain or loss by C corporations on the distribution of appreciated assets, subjecting such distributions to double taxation, commonly known as the repeal of the General Utilities doctrine. At the same time, only one level of tax was imposed on distributions by S corporations to shareholders, who simply increased the basis of their stock under § 1367(a) by the amount of recognized gain. To prevent conversion by C corporations to S corporations because of this difference, the 1986 Act revised § 1374 which had before 1986 imposed a double tax on certain net capital gains within 3 years of conversion from C status to S status.

2. Section 1374 - Imposition of the Tax.

Section 1374 now imposes a tax at the corporate level on the built-in gain recognized by former C corporations during the first 10 years after an S election, for existing C corporations that make S elections after 1986. There were transitional rules and some exceptions for "qualified corporations" which made the election before 1989. New corporations that make S elections effective from their beginning, and assets acquired and appreciation occurring during the time an S election is in effect, are not subject to this double tax. Assets which have a carryover basis from a C corporation or are acquired in nonrecognition transactions may also be subject to § 1374.

3. <u>How the § 1374 Tax Works</u>.

The tax imposed is calculated on "recognized built-in gain" during the 10 year recognition period. The tax is imposed on the net unrealized built-in gain of the assets in a C corporation owned at the time its election to be treated as an S corporation becomes effective, to the extent those same assets are disposed of by the S corporation during the first ten years the election is in effect. The net recognized built-in gain is taxed at the highest corporate rate under § 11. To the extent an S corporation has recognized built-in losses, these amounts reduce the recognized built-in gain to arrive at net recognized built-in gain, on which the tax rate is applied. Furthermore, the net recognized built-in gain cannot exceed the amount which would be the taxable income of the corporation if it were not an S corporation. This limitation operates to relieve the corporation from any § 1374 tax to the extent income can be deferred beyond the ten-year recognition period.

Recognized built-in gain cannot be reduced by NOL carryovers from prior S corporation years, but can be sheltered by NOL carryovers from C corporation years. § 1374(b)(2). Certain other credits carried forward from C years can be used to reduce the recognized built-in gain. § 1374(b)(3).

To determine the built-in gain or loss on any asset, valuations should be made for all assets owned by the C corporation at the time it files an S election. This will resolve any further dispute with the Internal Revenue Service to the extent it provides some accurate valuation of the property at the date of the S election for purposes of calculating built-in gain amounts. The tax is not imposed on gain from assets which are not owned by the corporation on the date it elects to be treated as an S corporation.

4. Effect on S Corporation Shareholders.

Any tax imposed on the built-in gain at the corporate level is treated by the S corporation's shareholders as a loss sustained by the S corporation. § 1366(f)(2). The loss obtains its character by allocating it proportionately among the recognized built-in gain items.

5. Limitation on Amount of Recognized Built-In Gains.

The net unrealized built-in gain of the former C corporation on the date of conversion to S corporation status is the excess of the total fair market value of the corporation's assets over its aggregate adjusted basis of its assets at the time of conversion, have an adjusted basis in excess of their fair market value reduce the amount of net unrealized built-in gain and thus, any amount subject to tax under § 1374.

G. EFFECTS OF DISTRIBUTIONS TO SHAREHOLDERS AND CORPORATIONS

1. No Accumulated Earnings and Profits.

Cash can be distributed tax-free to a shareholder to the extent of the shareholder's basis in his stock or debt. The distribution reduces the shareholder's basis in his stock, but not below zero. That portion of the distribution which exceeds the shareholder's basis is treated as gain from the sale or exchange of property. § 1368(b)(2). This is the case even thought the shareholder may have basis in obligations of the corporation to her. § 1368(b)(1).

A shareholder in an S corporation, unlike a partner under the applicable partnership rules, does not maintain an aggregate basis in his stock, but may have differing bases in separate shares of stock. Reg. § 1.1367-2(a) (prior law). However, one could read § 1368(b)(1), which refers to shareholder basis, as permitting an aggregate basis. Basis adjustments to an S corporation's stock are usually made at the end of a taxable year. It is this basis at the end of the year which is relevant for determining whether a distribution made through the year is taxable.

2. S Corporation with Accumulated Earnings and Profits.

Distributions out of prior earnings and profits are taxed as dividends. An "accumulated adjustments account" measures undistributed taxable income of the S corporation during the most recent period for which the S election is in effect. Distributions are deemed to be first out of these S corporation earnings, as stated in the accumulated adjustments account. These amounts distributed are nontaxable to the extend of the shareholder's basis in his stock. That which exceeds the amount in the accumulated adjustments account is treated as a dividend. See PLR 8808016. Once all accumulated earnings and profits are distributed, subsequent distributions are treated as above discussed. The corporation can elect to first take distributions as dividends, reducing accumulated earnings and profits.

If multiple distributions are made thought the year which exceed the accumulated adjustments account at the end of the year, the accumulated adjustments account amount is apportioned pro rata among distributions made during the year. If distributions exceed accumulated earnings and profits, it is necessary to also apportion these amounts, subject to subchapter C rules.

3. Liquidating Distributions.

Generally, if a C corporation distributes appreciated property, it recognizes gain at the corporate level to the extent of such appreciation. A second level of tax is recognized on distribution of the property to the shareholders if the corporation has accumulated earnings and profits or the distribution exceeds the shareholder's basis in their stock. § 301. However, if an S corporation distributes appreciated property, the gain recognized increases the shareholders' basis in their stock. This means that the distribution may not be taxed again to the shareholders. The gain recognized at the corporate level passes through to the S corporation's shareholders. However, as previously discussed, the built-in gain tax § 1374 may subject the S corporation to a corporate level tax.

4. Nonliquidating Distributions.

S corporations generally recognize gain but not loss on nonliquidating distributions of property, and the rules in § 311 apply to S corporations. Under § 311, a corporation recognized gain but not loss on a nonliquidating distribution of property. Any gain recognized is passed through to the shareholders. This increases the shareholders stock basis. The character of gain is determined at the corporate level. The § 1374 corporate level tax may be imposed if the S corporation is disposing of certain property.

H. INTERACTION BETWEEN S CORPORATION AND C CORPORATION RULES

1. Passive Loss Rules

Pursuant to § 469, deductions and losses related to passive activities are only deductible by taxpayers to the extent they participate in the management of the passive activity. Unlike limited partners, who usually fall captive to these rules because of their limited participation in the partnership's business, a shareholder in an S corporation can materially participate in the S corporation's activities. Consequently, S corporations may be more attractive than limited partnerships in this instance.

2. At Risk Rules

Code § 465 applies to individuals, trusts and estates including the holders of S corporation status, like the passive loss rules in § 469. An S corporation shareholder and a partner in a partnership are limited in their ability to deduct losses for nonrecourse debt to the extent they are "at risk" in the activity generating the loss. § 465(a)(1). An S corporation shareholder is at risk for the entire amount of a loan she makes to the corporation, but a partner is at risk for only a portion of the loan amount. Prop. Reg. § 1.465-10(c), (d); § 1,465-7(a).

3. Alternative Minimum Tax

C corporations are subject to the alternative minimum tax under § 55, from which S corporations are exempt. However, an S corporation's shareholder reports her proportionate share of the tax preference items attributable to the S corporation, and they retain the character they had at the corporate level. Former Reg. § 1.58-4.

Costs incurred after 1986 for mining exploration costs, mining development expenditures, and intangible drilling costs are expensed for regular tax purposes, but capitalized and amortized for alternative minimum tax purposes. §§ 56(a)(2), (b)(2)(A) and §§ 57(a)(2), (b). An S corporation shareholder may wish to elect to capitalize and amortize these costs which permits the S corporation shareholder to avoid exposure to alternative minimum tax which respect to those items.

4. Personal Holding Company Tax; Accumulated Earnings Tax

An S corporation is not subject to the personal holding company tax under § 541 or the accumulated earnings tax of § 531. § 1363(a). However, if an S corporation owns stock in a foreign corporation, it may trigger application of the personal holding company provisions. §§ 541-547. These provisions apply to a foreign corporation if more than 50% of its stock is owned directly or indirectly by five or fewer individuals and only 60% of its income is personal holding company income.

IV. TAXATION OF PARTNERSHIPS AND DISREGARDED ENTITIES

Entities taxed as "partnerships" or "disregarded" for federal income tax purposes have surged as a method of conducting active business due to tax reforms that have increased significantly the tax costs of conducting business in corporate solution. Because of these changes in tax law and policy, business lawyers must become as familiar with the rules and implications of partnerships and disregarded entities as they have been in the past with corporations.

A. Classification of Non-Corporate Entities For Federal Income Tax Purposes.

Even though an organization may be formed and properly qualify as either a general or limited partnership or a limited liability company for state law purposes, this characterization is not dispositive of the federal income tax treatment of the organization. Prior to 1996, the IRS had detailed classification regulations for determining an entities status as an association taxable as a corporation or a partnership under Federal tax law. See, prior Treas. Reg. §§301.7701-1 through -4. The new regulations simply have default entity classifications unless the entity elects otherwise. See, Treas. Reg. §§301.7701-1 through -4.

1. Overview of Classification Regulations.

Under the classification regulations, only corporations organized under state or federal law and certain foreign entities, all of which are set forth in Treas. Reg. §301.7701-2(b)(1) through -2(b)(8), are taxable as corporations. Any other domestic entity will be taxed as a partnership if it has two or more members or as a disregarded entity if it has a single owner. Treas. Reg. §3017701-3(b). This classification is the default classification under the regulations, and any non-corporate entity will only be taxable as a corporation if it makes an election on Form 8834. This election is why these regulations have been termed the "check the box" regulations. Entities formed prior to the effective date of the new regulations on January 1, 1997, will be taxable as they were prior to such date.

2. Election Out of Partnership Treatment. In addition, § 761(a) of the Code provides that partners may, pursuant to a specific election filed with the Service, be taxed as individual owners of property rather than as a partnership under Subchapter K. This election is available for partnerships organized and operated for investment purposes only or for joint production, extraction or use of property, but not for actively conducted businesses or selling of services or products. This election is primarily of interest to co-owners of investment property who wish to insure treatment as co-owners rather than as partners. A § 761(a) election can also be used in tiered partnerships where one partnership solely owns property in a subsidiary partnership. Once made, the § 761(a) election is irrevocable, unless the Service consents to revocation. The method of election is by affirmative election made within the time prescribed for filing of the partnership return for first taxable year that the election to be effective.

B. OVERVIEW OF DISREGARDED ENTITIES.

The classification as a disregarded entity under the regulations is for all federal income tax purposes, including employment and excise taxes. The IRS did issue a notice with regard to employment taxes in which a disregarded entity may elect to pay employment taxes directly instead of having the owner of the entity may pay the employment taxes. Notice 99-6, 1999-2 IRB 12. This election will impose liability for the employment taxes on the entity rather than the owner which may be desirable for example in a limited liability company where if the owner is responsible for paying employment taxes she will be responsible for all liability even though the entity is a limited liability company. The IRS is currently analyzing the whether excise taxes, such as black lung excise taxes, may be paid by the disregarded entity or if the owner is required to pay such taxes.

C. OVERVIEW OF INCOME TAX TREATMENT OF PARTNERSHIPS

Partnerships are not income taxpaying entities but act as conduits or pass-throughs, passing taxable income or loss to the equity owners based upon their distributive shares of partnership income, gain, loss, deductions and credits. Income taxes are thus paid only by the partners. The partnership files an annual information return on IRS Form 1065, together with Schedules K-1, which are the documents distributed to the various partners to inform them of the tax consequences which they must report on their individual income tax returns.

A unique feature of partnerships, which must be considered in analyzing their tax treatment, is the distinction between "inside basis" and "outside basis". Inside basis is the basis of the partnership in the various partnership assets; outside basis is the aggregate of each partner's basis in her partnership interest. This dichotomy reflects a competing set of themes in the tax treatment of partnerships, i.e., the distinction between treating a partnership in the aggregate or as an entity. In many ways, the partnership is merely an aggregate of the various partners' interests, for example the way distributive items are passed through to the individual partners. In other respects a partnership is an entity (albeit not an income taxpaying one), such as with respect to partnership elections and the treatment of transfers of partnership interests as transfers of specific interests themselves and not merely a share of aggregate partnership assets. In-depth study of partnership taxation often encounters the competing tensions between these aggregate and entity concepts.

Another important parallel found in partnerships is the distinction between taxable income and cash flow. In addition to passing through the partners' distributive shares of taxable income or loss, the partnership can distribute property or cash to the partners, and while the amount distributed may match taxable income, the two do not necessarily correlate. Thus, a partnership with no income may still distribute cash and, conversely, a partnership with taxable income (creating tax liabilities for the partners) may make no actual distribution, leaving the partners to satisfy tax liabilities from other sources. While this discussion will not cover more exotic varieties of partnerships, it is this basic distinction that allows variations in interests in the partnership, so that partners can receive a share of taxable income different from their sharing ratio for current cash distributions.

1. Organization of a Partnership.

a. Introduction. A Partnership is organized when the entity (generally a general partnership, limited partnership or limited liability company) is created under state law and property is transferred as a contribution to the capital of the partnership in exchange for which the contributing partner receives her interest in the partnership. Under § 721 neither the partnership nor its partners recognize gain or loss on the contribution of property to the partnership in exchange for an interest therein. The partner's basis in her partnership interest (i.e., her outside basis) is equal to the basis of the property contributed, together with the amount of any money contributed. Similarly, the basis of the property in the hands of the partnership (i.e., the partnership's inside basis) is a carry-over basis equal to the basis of the property in the hands of the contributing partner increased by the amount of any gain recognized by that partner on the contribution. Section 721(b) requires partners to recognize gain if the contribution is equivalent to a contribution to an investment company causing recognition of gain under § 351 (relating to tax-free organization of corporations).

Section 724 provides for recharacterization of subsequent gain or loss due to unrealized receivables or inventory items. (Defined in § 751).

These contributions provisions, in conjunction with liquidation provisions to be discussed subsequently, make partnerships particularly attractive for appreciating property, real estate for example, since property can be contributed to and distributed from the partnership in most cases without recognition of gain or loss. This provides a substantial advantage over the corporate form, particularly after restrictions of the <u>General Utilities</u>, doctrine causing more complete double corporate taxation.

b. <u>Receipt of Partnership Interests for Performance of Services</u>. Section 721 does not apply to the transfer of a partnership interest in exchange for services performed by the recipient, i.e., the "service partner". This can render the event taxable to both the partner and the partnership. If the service partner receives an interest in partnership capital, she is taxed on the fair market value of the interest at the time of receipt and the partnership recognizes a corresponding deduction as a guaranteed payment under § 707(c). However, if the service partner receives only an interest in future profits, the general rule appears to be that she does not recognize income on receipt.

c. <u>Transfers of Property to Partnership Other Than As Capital Contributions</u>. A capital contribution is not the only way to transfer property to a partnership. Section 721 does not apply to transaction between a partnership and a partner not acting as a partner, which are governed by § 707. Thus, if a partner sells property to the partnership in exchange for a partnership interest, it will be treated as a sale, causing the partner to recognize gain or loss and take a cost basis, i.e., for her outside basis, in the partnership interest received. Similarly, the partnership will take a cost basis, i.e., for its inside basis, in the assets acquired. The code and Regulations provide special rules for "disguised sales" to invoke the Code § 707 rules even when the transfer of property is clocked in the form of a "contribution."

d. <u>Partnership Contributions Subject to Liabilities</u>. If a partner contributes assets subject to a mortgage or other liability, she still recognizes no gain or loss under § 721; however, the basis determination is more complicated. Under § 722 the partner takes an outside basis in her partnership interest equal to the adjusted basis of property contributed, reduced by the portion of the liability which exceeds her percentage interest in the partnership.

The transaction is further complicated if the contributed property is subject to liabilities in excess of its basis. Then, the contribution results in a "negative basis" to the partner for her partnership interests. Under § 704, however, a partner's basis in her interest cannot be less than zero. Thus, the so called "negative basis" is converted into recognized gain under the liability and distribution rules of the Code.

e. <u>Partnership Contributions and Depreciation</u>. With regard to depreciable property, the partnership steps into the shoes of the contributor, continuing her depreciation methods and terms. Moreover, unless the property is contributed within 12 months of original acquisition, the partnership is bound by all ACRS and MACRS elections made by the contributing partner. However, under anti-churning rules, if the contributed property is nonresidential realty or residential rental property or if prior rules would be more favorable, ACRS tacking does not apply and the partnership must use the new rules.

2. Partnership Operations.

a. Distributive Shares of the Partners. Pass-through of partnership income and distributions of property are effected through each partner's distributive share. The "distributive share" is each partner's share of income, gain, loss, deduction or credit, which is determined by the terms of the partnership agreement unless otherwise provided by the Code. Under § 704(b) a partner's distributive share is determined in accordance with her interest in the partnership, based upon all relevant facts and circumstances, unless the partnership agreement expressly provides the partner's distributive share or the allocation expressly made in a partnership agreement does not meet the requirements of substantial economic effect.

b. Distributive Share of Contributed Property - Section 704(c). Special allocation is required for contributions of property to the partnership. Section 704(c) requires income, gain, loss and deduction with respect to contributed property to be shared to take account of the variation between the basis of the property at the time of contribution and its fair market value. Similar rules are specified for treatment of contributions by cash method partners of accounts payable or other accrued unpaid liabilities. For contributions of property with a fair market value greater than adjusted basis, the contributing partner receives a capital account equal to the fair market value of the property. However, her basis in the partnership interest pursuant to § 722 is equal to the basis of property. Similarly, the partnership takes a carryover basis in the property equal to its basis to the partner rather than its fair market value. This contribution creates a disparity between the partner's capital account and her outside basis and the partnership's inside basis in its assets versus fair market value.

If a partnership, receiving a contribution of appreciated property, were to immediately sell the property for its fair value, the gain recognized would be due to precontribution appreciation. Section 704(c) requires that gain and other tax consequences resulting from precontribution appreciation is to be allocated to the contributing partner. Therefore, a sale of depreciated property results in all gain being allocated to the contributing partner. However, actual distributions of cash and property are not governed by § 704(c), which applies only to distributive share for federal income tax purposes, while actual proceeds are distributed in accordance with the partners' respective interests in the partnership, assuming the agreement does not provide otherwise.

The effect in § 704(c) goes beyond allocation of gain on sale of the contributed property. In addition, it requires allocation to the contributing partner of losses with respect to property, as well as credits and deductions. Thus, depreciation deductions for contributed property will be specially allocated to give all or a part of the depreciation deduction to the noncontributing partners in order to offset, by the end of the depreciation period, the difference between the adjusted basis and the fair market value of property contributed. The effect of allocating depreciation deductions away from the contributing partner, of course, results in shifting a greater portion of income to the contributing partner, similar to the shifting of gain on the property to that partner.

c. <u>Special Allocations and Substantial Economic Effect Under Section 704(b)</u>. Section 704(b) requires that special allocations pursuant to partnership agreements be respected, unless they are determined to not have substantial economic effect. To explain this provision, the Service promulgated a complicated set of Regulations. The Regulations prohibit allocations of tax benefits among partners where the allocation is for tax purposes only and has no impact on the economics of the transaction. Thus, a partnership between two 50% partners cannot provide a special allocation of all of the losses to one partner or all the gains to another (which might be desired because of the particular tax situations of the individual partners) unless these allocations have substantial economic effect. In very brief summary, economic effect is satisfied where the allocation is reflected in the capital accounts of the parties, capital accounts must be respected and the parties are required to restore deficits to capital accounts (in the absence of certain other special provisions provided in the Regulations).

Due to extreme complexity of the special allocation regulations, a detailed discussion is beyond the scope of this chapter. In brief, the Regulations set forth general provisions and detailed analysis to determine both economic effect and substantially, which are independent elements and must be satisfied to respect the special allocation. In addition, the Regulations contain detailed provisions with regard to contributions and distributions of property, adjustments to reflect book value and provisions regarding partnerships with nonrecourse debt and requirements for substantial economic effect in such instances.

3. Determination of Basis in Partnership Interests.

a. Computation and Adjustment of Outside Basis. As had been indicated, a partner's outside basis of her partnership interest is initially equal to the basis of property contributed or the amount of cast contributed to the partnership, pursuant to § 722 of the Code. Outside basis is subsequently adjusted pursuant to § 705(c) of the Code. Basis is increased by each partner's distributive share of partnership taxable income, income of the partnership exempt from federal income tax and the excess of depletion deductions over the basis of property subject to depletion (generally applicable to mining and oil and gas partnerships). In addition, the partner's outside basis is increased by subsequent contributions to capital of the partnership.

Conversely, outside basis is reduced, but not below zero, by distributions received by a partner from the partnership, and her distributive share of partnership losses, expenditures not deductible in computing taxable income nor chargeable to capital account and deductions for depletion for oil and gas property to the extent not exceeding the proportionate share of adjusted basis of property allocated to that partner.

b. Impact of Partnership Liabilities on Outside Basis. An important rule for partnership basis, and the primary reason partnerships were predominant tax shelter vehicles, is that each partner receives an increase in her outside basis equal to the amount of her proportionate share of partnership liabilities. Thus, whenever the partnership incurs a liability, each partner is deemed to have made a contribution of money to the partnership in the amount of her share of the liabilities. Similarly, if any partner increases her share of liabilities that increase is considered an additional contribution of money. This deemed contribution results in an increase in the partner's outside basis pursuant to § 722.

Conversely, to the extent any partner decreases her share of partnership liabilities, or the partnership is freed from its liabilities or a partner is released from her share of such liabilities, the decrease is treated as distribution of money by the partnership to the partner. The effect of this deemed distribution is to reduce the partner's outside basis pursuant to § 705(a)(2). In addition, such a deemed money distribution can result in recognition of gain to the partner to the extent the money distributed exceeds her adjusted basis in the partnership interest immediately before the distribution.

c. Outside Basis as a Limitation on Partnership Losses. Section 704(d) provides that a partner is allowed her distributive share of partnership loss only to the extent of her adjusted basis in her adjusted basis in her partnership interest at the end of the partnership year in which the loss occurred. Any excess loss is carried-over and allowed as a deduction only when such basis is subsequently increased. Section 704(d) tests allowability of losses against the adjusted outside basis at the end of the partnership year in which the loss occurred. Therefore, it is possible to recognize losses during the year and make a contribution to capital or take other action to increase the partner's outside basis at the end of the tax year.

The Code § 704(d) loss limitation is also relevant in terms of allowance of partnerships losses in connection with the passive loss restrictions and at-risk rules introduced and expanded in the 1986 Act. In new Code § 469 enacted in 1986, if a taxpayer does not materially participate in partnership activities, including by definition any limited partner (but not member of a limited liability company), she may only take losses from that activity against other passive activity losses. If a partner has no other passive activities, losses generated by the partnership cannot be taken by the partner and must be carried over indefinitely until passive activity income is present to absorb the losses or the interest in the partnership is entirely terminated. Similarly, a partner can have losses currently disallowed and suspended where she does not have sufficient amounts "at risk" in the activity. The at-risk rules of §465 generally apply to certain nonqualified nonrecourse debt incurred by the partnership for certain activities.

The rules of Code § 465 and 469, together with the loss limitations of Code § 704(d), provide restrictions on partnerships losses and their availability to the partner to offset her individual income. In terms of ordering, the partner first must clear the hurdle of Code § 704(d), next the at-risk rules of Code § 465, and finally the requirements of Code §469. It is thus possible that a partner can simultaneously have outstanding losses suspended under Code §§ 704(d), 465 and 469.

Unlike the requirements for suspended losses under Code § 469, providing that losses are taken in full the sale or disposition of the interest in the passive activity, it appears that suspended losses under Code § 704(d) disappear when a partner sells her interest or her interest is liquidated. Similarly, there is no authority to support the transfer of suspended Code § 704(d) losses to a transferee partner when a partner sells her partnership interest. Therefore, in most cases a selling or liquidation partner should take action, if possible, to restore basis in order to claim suspended losses prior to sale or liquidation.

4. Transfers of Partnership Interests.

a. Sale of Partnership Interests. Under Code § 741 a partner recognizes capital gain or loss on the sale or exchange of a partnership interest. Thus, the transfer is treated as the sale of a separate ownership interest and not the sale of a partner's aggregate interest in the partnership assets, such as the treatment of a sale of a sole proprietorship business. The transferee partner purchasing the interest takes a basis from the partnership interest equal to her cost, following the general basis rules of Code §§ 1011 et seq. Section 741 does require recharacterization of gain as ordinary income where the partnership has substantially appreciated inventory items or unrealized receivables, as provided in § 751 (discussed below).

b. Section 754 Elections and Basis Adjustments Under § 743. The transfer of a partnership interest does not solely involve the "outside" level, i.e., gain or loss to the selling partner and the cost basis to the purchasing partner. A special provision under § 743 of the Code allows a partner who purchases a partnership interest to make an optional adjustment to the inside basis of partnership property, but only with respect to that transferee partner.

The purpose of Code § 743 adjustment is to prevent disparity between the inside and outside basis with regard to the particular partner's interest. For example, assume a one-third partner in a three-person partnership has an outside basis of $100 and the partnership's inside basis for her one-third portion is also $100 resulting in equality of inside and outside basis. However, if the fair market value of the partnership's property is $600, the partner's interest has a value of $200, exceeding her basis by $100 of unrealized appreciation. If the partner sells her interest for $200, she recognizes $100 gain and her transferee takes a $200 cost basis in the partnership interest under § 742. However, the partnership's inside basis with regard to the transferee partner's interest remains at $100. There is a potential that the transferee partner will again be subject to gain on the inside unrealized depreciation, which gain would in essence be taxed once to the transferor partner and again to the transferee. The § 743 basis adjustment avoids this result by allowing a step-up of inside basis, with respect to the transferee partner alone, equal to her outside basis in the partnership interest.

In addition to the § 743 basis adjustment on sale or exchange of a partnership interest, a § 754 election also causes another inside basis adjustment under § 734 when a partnership distributes property to a partner. The effect of the adjustment is to increase the adjusted basis of remaining partnership property by the amount of gain recognized by the distributing partner under § 731(a)(1), and any excess of the adjusted basis to the partnership of distributed property (other than money) for liquidating and nonliquidating distributions over the adjusted basis to the distributee. The § 734 adjustment further provides for a decrease in adjusted basis of property (i) where the distributing partner would recognize a loss under § 731(a)(2) or, (ii) where in the case of liquidating distributions, the basis to the partnership of property distributed is less than the partner's outside basis in her partnership interest, the result of which would be to lose potential gain recognition because of the resulting basis step-up to the partner. In the case of such decreases, the gain or depreciation potential is preserved by way of a reduced basis in remaining partnership assets.

A basis adjustment made under Code § 734 is allocated amount partnership assets according to the rules of Code § 755, which generally allocates increases or decreases in adjusted basis of partnership property so as to reduce the difference between fair market value and adjusted basis of partnership properties, except as otherwise permitted by Regulation. Under rules of § 755(b) and the Regulations, allocation is made by separating the assets between capital assets and § 1231 trade or business property, and other partnership property, which is generally ordinary income property.

c. Section 732(d) Adjustments Without § 754 Election. With regard to basis adjustments and Code § 754 elections, a special rule provides a limited basis adjustment in situations where a Code § 754 election was not in effect. Under Code § 732(d), if a partner acquired all her interests by a transfer under Code § 741, and then receives a distribution of property other than money with respect to that transferred interest within two years following the transfer, the partner may elect to treat the adjusted partnership basis of property as if a Code § 743(b) adjustment had been made at the time of the initial transfer.

d. Recharacterization For Unrealized Receivables and Inventory Items - Collapsible Partnership Provisions. Section 751 contains a special rule designed to recharacterize capital gains as a result of partnership distributions or sales or exchanges of partnership interest where the partnership has unrealized receivables or substantially appreciated inventory items.

1) "Unrealized receivables" is a broad term including both rights to future income, not yet taken into income for good or services, as well as ACRS recapture under §§ 1245 and 1250, at least in regard to distributions, liquidations and sales of partnership interests under §§ 731, 736 and 741.

2) "Inventory items" is defined in § 751(d) and includes ordinary income-type inventory items (as defined in §1221(1)) and other property which would not be treated as a capital asset or § 1231 property on sale or exchange by the partnership.

3) Section 751 only applies to "substantially appreciated" inventory items, which covers property if the fair market exceeds a 120% of adjusted basis in the hands of the partnership.

Section 751 is only triggered when a partner receives a disproportionate distribution of either code § 751 property (i.e., unrealized receivables and substantially appreciated inventory items) or other partnership property. In such instances, the distribution is treated as a sale or exchange of the property between the distributing partner and the partnership, as constituted after the distribution, resulting in recognition of gain by the distributing partner and the partnership.

While the foregoing discussion provides a general overview of Code § 751, the actual mechanics and operation can be fearsomely complex. For purposes of general understanding of partnership taxation, it is primarily important to remain alert of the existence of Code § 751 and remain alert for transfers or distributions which could affect Code § 751 property. In the event a potential issue arises, more detailed analysis must then be undertaken.

e. <u>Additional Consequences of Transfers of Partnership Interests</u>. Transfers of partnerships interests can have ancillary consequences for both the partners and the partnership. Under Code § 708(b)(1)(B) if 50% or more of the total interests in partnership capital and profits is sold or exchanged during any 12-month period, the partnership terminates for federal income tax purposes. As a result of termination the partnership ends, distributing its property to the partners, who are then deemed to have recontributed the property. These deemed transactions must be tested under Code §§ 721, 731 and 751 to determine any adverse tax consequences. On distributions, any cash assets, including marketable securities, could cause gain recognition if the value of these assets exceed the Partners' outside bases. One other common consequence of such termination is triggering of investment tax credit recapture.

5. Relations Between Partners and the Partnership.

Generally, contributions to the partnership by partners and distributions from the partnership to the partners are treated as such. However, § 707 of the Code provides for different treatment where a partner acts other than in her capacity as a partner in transactions with a partnership. This allows a partner to sell property to the partnership and treat the transaction as a sale rather than as a contribution and subsequent distribution of cash.

a. Disguised Sales. In the mid-1980's, Congress restricted the availability of partners to plan by using the contribution rules to avoid a gain-recognition ("sale") transaction. The effect of Code § 707(a)(2) is to treat provision of certain services and transfers of property as "sales"rather than as a contribution and a distribution.

The Service issued Regulations under Code § 707 setting forth very stringent presumptions to treat many distributions as disguised sales. However, with careful planning there still may be ways whereby a partner can contribute property to a partnership and receive cash as a partnership distribution and avoid treatment of the transaction as a Code § 707(a) sale, particularly where liabilities of the partnerships are involved and the partner receiving the distribution does not take a reduced portion of partnership liabilities.

b. <u>Guaranteed Payments</u>. Similar treatment is provided under § 707(c) for "guaranteed payments" received by a partner to be treated as payments for services resulting in taxable income to the partner and a trade or business expense to the partnership. Such guaranteed payments are principally used in partnerships where the managing partner or general partner, in the case of a limited partnership, wishes to receive certain payments as services or fees rather than as a distribution of her share of the partnership. Guaranteed payments are similar to § 707(a) transactions, except that the payment is treated as other than for partnerships purposes only for purposes of § 61(relating to gross income of the partner) and § 162 (relating to deductions of the partnership). For all other purposes it is treated as a partnership distribution.

While guaranteed payments must be made without regard to partnerships income, the Service has ruled that guaranteed payments can be other than fixed amounts and can relate to partnership gross income. Both § 707(a) and § 707(c) require matching of income recognition by the general partner and deduction of the payment by the partnership. It should be noted that deductibility of the fee by the partnership may be limited by the capitalization rules of § 263, as well as the new uniform capitalization rules of § 263A.

c. <u>Related Party Transactions</u>. In a different vein, § 707(b) provides restrictions on sales or exchanges of property between a partner and a controlled partnership. Control for this purpose is generally defined as ownership, directly or indirectly, of more than 50% in the capital or profits interests of a partnership, or for affiliated partnerships if the same persons directly or indirectly own more then 50% of the partnership interest. Under

§ 707(b)(1), losses are disallowed on exchange of property, other than an interest in the partnership, between the partnership and a controlling person or between two affiliated partnerships. Conversely, § 707(b)(2) acts as a recharacterization provision treating gains from covered sales and exchanges as ordinary income, similar to the general related party provisions of § 1239. Attribution of ownership of partnership interest shall be determined using the constructive ownership rules of § 267(c) relating to corporate stock.

6. <u>Nonliquidating or Current Distributions</u>.

Assuming a partner does not engage in transactions under § 707(a) or (c) outside of her capacity as a partner, any property received by her from the partnership will be treated as either a current or liquidating distribution. For current, or nonliquidating distributions, the partner recognizes gain only to the extent "money" distributed exceeds her adjusted outside basis in her partnership interest. Note, "money" for this purpose also includes marketable securities as defined under Code § 731(c)(2), except in three situations set forth in Code § 731(c)(3). Loss is only recognized on liquidating distributions and not on current distributions. The basis rules of § 732(a) provide that a partner receiving a current distribution takes as her basis in property other than money the adjusted basis to the partnership prior to the distribution. This carry-over basis is limited, however, and shall not exceed the adjusted basis of the distributing partner in her partnership interest reduced by any money distributed in the same transaction. This limitation can result in a basis adjustment under § 734 when the partnership has a valid § 754 election in effect, as well as an elective § 732(d) adjustment. Also as previously discussed, current liquidation must be tested for gain under § 751(b) or disproportionate distributions of § 751 assets or other partnerships properties, including money.

As has been previously indicated, the availability of essentially tax-free distributions is one of the primary income tax benefits of operating in partnership form. So long as a partner has sufficient outside basis in her partnership interest, she can receive distributions tax free. Further, the inclusion of partnership liabilities in basis generally provides a sufficient cushion for such distribution.

Many service-type partnerships, such as medical or law practices, do not involve significant liabilities and also are based upon numerous current distributions for distributing cash to members of the firm. Because the basis adjustments for taxable income of the partnership are determined under § 705 as of the close of the partnership year, a partner can be placed in the position of having sufficient income as of the end of the year to support distributions yet being taxed on distributions made during the year because of insufficient basis. To prevent this timing disparity, the § 731 regulations provide that, for purposes §§ 705 and 731, a partner may take an advance or "draw" against her distributive share, which will be treated as a current distribution made on the last date of the partnership year with respect to that partner. Thus, it is important that current distributions be structured as draws if there is insufficient basis prior to the end of tax year to avoid recognition of gain under § 731.

7. Liquidating and Retiring Distributions.

a. Liquidating Distributions. Upon liquidation of the partnership, distributions are treated in substantially the same manner as non-liquidating distributions, including the treatment of "hot assets" under Code § 751 . However, unlike non-liquidating distributions, the partner may recognize loss upon a liquidating distribution but only if no property other than unrealized receivables (Code § 751(c)) and inventory (Code § 751(d)) is distributed to such partner. Again, the partnership is not taxable on such distributions, and the partner takes a basis determined under Code § 732(b) equal to the partner's adjusted basis in the partnership reduced by any money distributed.

b. Payments to Retiring and Deceased Partners. When a partner withdrawals completely from a continuing partnership, Code § 736 determines the character of payments to such partner from the partnership especially when such payment will be made in a series to the retiring partner. Code § 736 does not govern sales or exchanges of partnership interests only payments from the partnership. Under Code § 736 payments are either classified as a distribution to the partner (Code § 736(b)) or as a distributive share or guaranteed payment to the partner (Code § 736(a)). Generally, payments made for a partnership interest are treated under Code § 736(b) as a distribution from the partnership. However, if capital is not a material income producing factor for the partnership and the partner was a general partner in the partnership, payments in exchange for unrealized receivables or good will (provided that the partnership agreement does not specifically provide for payments for good will) are considered as distributive share payments or guaranteed payments under Code §736(a). Only distributions which are not treated as Code § 736(b) payments are treated as distributive shares or guaranteed payments under Code § 736(a).

Generally, the continuing partnership desires for the payments to be treated as a distributive share payment to the retiring partner as it reduces the income of the partnership. The retiring partner generally desires for the payments to be treated as distributions from the partnership as it provides a favorable capital gains tax rate. Consequently, the partnership should clearly establish how retiring payments are to be treated in advance of any partner retiring to clarify the treatment of such payments. Again, the continuing partnership may desire to have an election under Code § 754 in place in the event of a Code § 736(b) payment in order to obtain a step-up in basis in the partnership assets.

c. Dissolution of Partnership. A partnership is considered as dissolved or terminated for federal income tax purposes if (i) no part of any business, financial operations, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (ii) within a twelve month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Code §708.

Special rules are provided for merger or consolidation of partnerships as well as partnership divisions. In addition, a partnership is deemed for federal income tax purposes as continuing as if not terminated, regardless of dissolution pursuant to state law.

It is thus important to remain aware of the interplay between the termination and liquidation provisions of the Code and the dissolution and winding-up provisions under state law.

8. Incorporation of Partnership.

For various reasons it might be decided to convert business operated in partnership form to a corporation. While, as a general matter, dissolution of a partnership and formation of a corporation are generally tax-free under §§ 351 and 731 of the Code, the form of the transaction can have consequences on the outcome of tax purposes.

There are three methods to incorporate a partnership: (1) the partnership can liquidate and distribute its assets to the partners, who in turn contribute those assets to form the corporation in a § 351 transaction; (2) the partnership can contribute its assets to the corporation in a § 351 transaction and then immediately dissolve and distribute the corporate stock to its partners; and (3) the various partners can contribute their partnerships interests to the corporation under § 351, which results in termination of the partnerships for federal income tax purposes pursuant to § 708(b)(1)(B) and dissolution of the partnership under state law since there would no longer be two or more partners and from this dissolution the assets pass to the corporation which holds them directly.

Regardless of the form of the transaction, the end result is holding of partnerships assets by a corporation, to stock of which is owned by the former partners. Prior to 1984 the Service contended that, regardless of the form of the transaction, the substantive effect was the same for federal income tax purposes. Thus, regardless of form, the transaction would be treated for tax purposes under the second alternative whereby the partnership transfers all its assets under § 351 to the corporation and distributes its stock to the partners. Because the form of the transaction can in fact have different tax consequences, the Service subsequently reversed its position and held that it would respect whatever formal method was chosen to reflect the transaction.

C0676382.1

FEDERAL TAX CONSIDERATION IN
CHOICE OF BUSINESS ENTITY

APPENDIX

Filed in the Office
of Secretary of
State of West
Virginia this date:

ARTICLES OF INCORPORATION

OF

ACME CORPORATION

The undersigned, acting as incorporators of a corporation under Section 202, Article 2, Chapter 31D of the Code of West Virginia, adopt the following Articles of Incorporation of such corporation:

ARTICLE I

The undersigned agree to become a corporation by the name of ACME Corporation.

ARTICLE II

The address of the principal office of said corporation will be 101 Coal Building, City of Charleston, County of Kanawha, State of West Virginia, 25310.

ARTICLE III

This corporation is formed for the purpose of transacting any or all lawful business for which corporations may be formed under the corporation laws of the State of West Virginia.

ARTICLE IV

No shareholder of this corporation or other person shall have any preemptive right whatsoever.

ARTICLE V

The amount of the total authorized capital stock of said corporation shall be Ten Thousand Dollars ($10,000.00), which shall be divided into Ten Thousand (10,000) shares of the par value of One Dollar ($1.00) each.

ARTICLE VI

The existence of this corporation is to be perpetual.

ARTICLE VII

Provisions for the regulation of the internal affairs of the corporation are:

A. Indemnification. Each person who was or is a party or is threatened to be made a party to or is involved (including, without limitation, as a witness or deponent) in any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative, investigative or otherwise in nature ("Proceeding"), by reason of the fact that he or she, or a person of whom he or she is the legal representative, is or was a director or officer of the corporation or is or was serving at the written request of the corporation's Board of Directors, president or their delegate as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, whether the basis of such Proceeding is alleged action or omission in an official capacity as a director, officer, trustee, employee or agent or in any other capacity, shall be indemnified and held harmless by the corporation to the fullest extent authorized by law, including but not limited to the West Virginia Code, as the same exists or may hereafter be amended (but, in the case of any such amendment, only to the extent that such amendment permits the corporation to provide broader indemnification rights than said Code permitted the corporation to provide prior to such amendment), against all expenses, liability and loss (including, without limitation, attorneys' fees and disbursements, judgments, fines, ERISA or other similar or dissimilar excise taxes or penalties and amounts paid or to be paid in settlement) incurred or suffered by such person in connection therewith; provided, however, that the corporation shall indemnify any such person seeking indemnity in connection with a Proceeding (or part thereof) initiated by such person only if such Proceeding (or part thereof) was authorized by the Board of Directors of the corporation; provided, further, that the corporation shall not indemnify any person for civil money penalties or other matters, to the extent such indemnification is specifically not permissible pursuant to federal or state statute or regulation, or order or rule of a regulatory agency of the federal or state government with authority to enter, make or promulgate such order or rule. Such right shall include the right to be paid by the corporation expenses, including, without limitation, attorneys' fees and disbursements, incurred in defending or participating in any such Proceeding in advance of its final disposition; provided, however, that the payment of such expenses in advance of the final disposition of such Proceeding shall be made only upon delivery to the corporation of an undertaking, by or on behalf of such director or officer, in which such director or officer agrees to repay all amounts so advanced if it should be ultimately determined that such person is not entitled to be indemnified under this Article or otherwise. The termination of any Proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interest of the corporation, or that such person did have reasonable cause to believe that his conduct was unlawful.

B. Right of Claimant to Bring Suit. If a claim under this Article is not paid in full by the corporation within thirty days after a written claim therefor has been received by the corporation, the claimant may at any time thereafter bring suit against the corporation to recover the unpaid amount of the claim and, if successful, in whole or in part, the claimant shall be entitled to be paid also the expense of prosecuting such claim. It shall be a defense to any such action (other than an action brought to enforce a claim for expenses incurred in defending or participating in any Proceeding in advance of its final disposition where the required undertaking has been tendered to the corporation) that the claimant has not met the standards of conduct which make it permissible under the applicable law for the corporation to indemnify the claimant for the amount claimed, but the burden of proving such defense shall be on the corporation.

Neither the failure of the corporation (including its Board of Directors, independent legal counsel, or its shareholders) to have made a determination prior to the commencement of such action that indemnification or reimbursement of the claimant is permitted in the circumstances because he or she has met the applicable standard of conduct, nor an actual determination by the corporation (including its Board of Directors, independent legal counsel, or its shareholders) that the claimant has not met such applicable standard of conduct, shall be a defense to the action or create a presumption that the claimant has not met the applicable standard of conduct.

C. Contractual Rights: Applicability. The right to be indemnified or to the reimbursement or advancement of expenses pursuant hereto (i) is a contract right based upon good and valuable consideration, pursuant to which the person entitled thereto may bring suit as if the provisions hereof were set forth in a separate written contract between the corporation and the director or officer, (ii) is intended to be retroactive and shall be available with respect to events occurring prior to the adoption hereof, and (iii) shall continue to exist after the rescission or restrictive modification hereof with respect to events occurring prior thereto.

D. Requested Service. Any director or officer of the corporation serving, in any capacity, (i) another corporation of which five percent (5%) or more of the shares entitled to vote in the election of its directors is held by the corporation, or (ii) any employee benefit plan of the corporation or of any corporation referred to in clause (i), shall be deemed to be doing so at the request of the corporation.

E. Non-Exclusivity of Rights. The rights conferred on any person hereunder shall not be exclusive of and shall be in addition to any other right which such person may have or may hereafter acquire under any statute, provision of the Certificate of Incorporation, Bylaws, agreement, vote of shareholders or disinterested directors or otherwise.

F. Insurance. The corporation may purchase and maintain insurance, at its expense, to protect itself and any director, officer, employee or agent of the corporation or another corporation, partnership, joint venture, trust or other enterprise against such expense, liability or loss, whether or not the corporation would have the power to indemnify such person against such expense, liability or loss under West Virginia law.

G. Limitation of Liability. A director of the corporation shall not be personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director except to the extent that such exception from liability or limitation thereof is not permitted by the West Virginia Business Corporation Act or the laws of the United States or the State of West Virginia, as the same may exist or are hereafter amended. Any repeal or modification of the foregoing provision by the stockholders of the corporation shall not adversely affect any right of protection of a director of the corporation existing at the time of such repeal or modification.

ARTICLE IX

The full name and address of the appointed person to whom notice or process may be sent is John Doe, 101 Coal Building, Charleston, West Virginia 25301.

ARTICLE X

The number of directors constituting the initial Board of Directors of the corporation is four (4), and the names and addresses of the persons who shall serve as directors until the first meeting of the shareholders or until their successors are elected and shall qualify are:

John Doe
232 Dogwood Lane
Charleston, WV 25312

Frank Smith
1481 Circle Drive
Nitro, WV 25672

George Jones
1121 Bridge Road
Dunbar, WV 25814

Mary Johnson
Route 58, Box 31
Madison, WV 25130

ARTICLE XI

The name and address of the Incorporator is John Doe, 232 Dogwood Lane, Charleston, West Virginia 24312.

THE UNDERSIGNED, for the purposes of forming a corporation under the laws of the State of West Virginia, does make and file these Articles of Incorporation, and have accordingly hereto set his respective hand this 1st, day of February, 2003.

/s/ John Doe
JOHN DOE

ARTICLES OF INCORPORATION
PREPARED BY:

JANE JOHNSON
BATTAM, BARTLEY & JOHNSON
123 Legal Avenue
Charleston, WV 25301

MINUTES OF ORGANIZATIONAL MEETING
OF
BOARD OF DIRECTORS
OF
ACME CORPORATION

The organizational meeting of the Board of Directors of Acme Corporation, a West Virginia corporation, was held in the offices of the Corporation, 101 Coal Building, City of Charleston, County of Kanawha, State of West Virginia, the 1st day of February, 2003, at 10:00 a.m., pursuant to call by the initial Board of Directors and written waiver of notice signed by the Directors of the Corporation

The following persons were present: John Doe, Frank Smith, George Jones and Mary Johnson, being all of the Directors of the Corporation.

John Doe was chosen Chairman of the meeting, and George Jones was chosen Secretary of the meeting.

The Secretary exhibited to the meeting the waiver of call and notice of the meeting duly executed by all the Directors of the Corporation

On motion duly made and unanimously adopted, it was ordered that said waiver of notice be attached to and made a part of the minutes of this meeting

The Chairman exhibited to the meeting the Certificate of Incorporation of this Corporation issued by the Secretary of State of the State of West Virginia on July 1, 2000, together with the Articles of Incorporation of this Corporation filed in the office of the Secretary of State by the incorporator on that date

> On motion duly made, seconded and unanimously carried, it was
> RESOLVED, that the Certificate of Incorporation of this Corporation, as issued by the Secretary of State of the State of West Virginia, and the Articles of Incorporation of this Corporation filed in the office of the Secretary of State of the State of West Virginia be, and the same are hereby, approved and that the original of said Certificate of Incorporation be forthwith filed

for record in the office of the Clerk of the County Commission of Kanawha County, West Virginia.

The Chairman presented a form of By-Laws prepared by counsel for the Corporation which was read article by article and as a whole.

On motion duly made, seconded and unanimously carried, it was RESOLVED, that the By-Laws, a copy of which has been presented to this meeting, be, and they hereby are, approved and adopted as and for the By-Laws of this Corporation.

The Chairman called for nominations for the election of officers of the Corporation. Nominations having been made, the following officers were unanimously elected:

President John Doe
Vice PresidentFrank Smith
SecretaryGeorge Jones
TreasurerMary Johnson

each to hold his office until his successor shall have been chosen and qualified, or otherwise as approved by the By-Laws. The compensation to be paid the officers of the Corporation for their services shall be as determined by the Board of Directors from time to time.

The Chairman presented to the meeting an impression of a corporate seal for the Corporation in the form which appears below.

On motion duly made, seconded and unanimously carried, it was RESOLVED, that the form of seal which has been submitted to this meeting be, and it hereby is, approved and adopted as the corporate seal of this Corporation.

The Chairman then presented a proposed form of printed certificate for shares of stock of the Corporation.

On motion duly made, seconded and unanimously carried, it was RESOLVED, that the form of certificate representing shares of capital stock of this Corporation, which has been submitted to this meeting, be attached to and made part of the minutes of this meeting, and the same is hereby approved in all respects and adopted as the form of certificate to represent the shares of the capital stock of this Corporation

The Chairman then stated that it was necessary to consider the initial issuance of the Corporation's capital stock. Thereupon, upon motion duly made and seconded, the following resolutions were unanimously adopted:

WHEREAS, there is not now outstanding any offering or portion thereof of this Corporation to sell or issue any of its common shares or any of its authorized but unissued shares; and

WHEREAS, it is deemed advisable by the Board of Directors that this Corporation offer for sale and issue its common shares; and

WHEREAS, under the Articles of Incorporation of this Corporation there is authorized Ten Thousand (10,000) shares of common stock of a par value of One Dollar ($1.00) per share; and

WHEREAS, John Doe, Frank Smith, George Jones and Mary Johnson have subscribed to a total of Five Thousand (5,000) shares of such stock at a price of One Dollar ($1.00) per share;

RESOLVED, that the President and Secretary of this Corporation be, and they hereby are, authorized and directed to execute and deliver certificates for the following number of common shares of this Corporation to the following persons and in the manner hereinbefore indicated:

NAME	SHARES	SUBSCRIPTION PRICE
John Doe	2,000	$2,000
Frank Smith	1,000	$1,000
George Jones	1,000	$1,000
Mary Johnson	1,000	$1,000

FURTHER, RESOLVED, that said shares, when issued, shall be fully paid and nonassessable; and

FURTHER, RESOLVED, that the President and Secretary of the Corporation be, and they hereby are, authorized and directed, from time to time, to execute certificates for the issuance of additional authorized common shares of the Corporation, without further action from the Board of Directors for consideration equal in amount to be no less than One Dollar ($1.00) per share of the common shares to be issued

The Chairman then stated that it was necessary to consider the authorization of officers of the Corporation to enter into contract on behalf of the Corporation.

On motion duly made, seconded and unanimously carried, it was RESOLVED, that John Doe and Mary Johnson, and each of them, are authorized and directed to enter into such contracts, on behalf of the Corporation, including contracts for the purchase, or loan, of equipment, supplies and materials for use by the Corporation and contracts for work to be performed by the Corporation, as they shall determine to be in the best interest of the Corporation, and upon such terms as to price, rental, interest rate or carrying charge on deferred payments, security given, and otherwise as they shall deem appropriate.

The Chairman stated that it was necessary to consider opening bank accounts for the Corporation.

On motion duly made, seconded and unanimously carried, it was RESOLVED, that the officers of this Corporation be, and they hereby are, authorized to open one or more checking accounts at West Virginia National Bank; and

FURTHER, RESOLVED, that the following officers of the Corporation were authorized to sign the checks of the corporation drawn upon funds deposited by it in the bank, namely, John Doe and Mary Johnson; and, further, that the Secretary of the Corporation was authorized to execute and file with said bank a form prepared by said bank, a copy of which is attached hereto and made a part of the minutes of this meeting, indicating the adoption of this resolution.

The Chairman next stated that it was necessary to consider obtaining workers' compensation coverage for the Corporation.

On motion duly made, seconded and unanimously carried, it was RESOLVED, that the officers of the Corporation be, and they hereby are, authorized and directed to cause the Corporation to obtain workers' compensation coverage for the employees of the Corporation.

There being no further business, the meeting was adjourned.

CHAIRMAN

SECRETARY

WAIVER OF NOTICE OF ORGANIZATIONAL MEETING
OF
BOARD OF DIRECTORS
OF
ACME CORPORATION

The undersigned, being the Directors of Acme Corporation, a West Virginia corporation, hereby waive all notice of the organizational meeting of the Board of Directors of said Corporation and consent and agree that such meeting of the Board of Directors shall be held in the offices of the Corporation, 101 Coal Building, City of Charleston, County of Kanawha, State of West Virginia, on the 1st day of February, 2003, at 10:00 a.m., for the purpose of adopting the by-laws, electing officers and such other business as may come before said meeting.

Dated this 1st day of February, 2003

JOHN DOE

FRANK SMITH

GEORGE JONES

MARY JOHNSON

CALL OF ORGANIZATIONAL MEETING
OF
BOARD OF DIRECTORS
OF
ACME CORPORATION

TO: Acme Corporation

Please be advised that the undersigned Director of Acme Corporation has called the organizational meeting of the Board of Directors of said Corporation to be held in the offices of the Corporation, 101 Coal Building, City of Charleston, County of Kanawha, State of West Virginia, the 1st day of February, 2003, at 10:00 a.m., for the purpose of adopting by-laws, electing officers and the transaction of such other business as may come before the meeting.

Dated this 1st day of February, 2003.

JOHN DOE, Director

BY-LAWS
OF
ACME CORPORATION

ARTICLE I OFFICES

The principal offices of the Corporation shall be located in the City of Charleston, County of Kanawha, State of West Virginia. The Corporation may have such other offices, either within or without the State of West Virginia, as the Board of Directors may designate or as the business of the Corporation may require from time to time.

ARTICLE II SHAREHOLDERS

Section 1. Annual Meeting. The annual meeting of the shareholders shall be held on the second Monday in the month of August in each year, at the hour of 10:00 a.m., local time, or at such other time on such other day within such month as shall be fixed by the Board of Directors, for the purpose of electing directors and for the transaction of such other business as may come before the meeting. If the day fixed for the annual meeting shall be a legal holiday in the State of the principal office of the Corporation, such meeting shall be held on the next succeeding business day.

Section 2. Special Meetings. Special meetings of the shareholders, for any purpose or purposes, may be called by the Chairman of the Board, if any, President, Secretary or by the Board of Directors, and shall be called by the President at the request of the holders of not less than one-tenth of all outstanding shares of the Corporation entitled to vote at the meeting.

Section 3. Place of Meeting. The Board of Directors may designate any place, either within or without the State of West Virginia, as the place of meeting for any annual meeting or for any special meeting called by the Board of Directors. If no designation is made, or if a special meeting be otherwise called, the place of meeting shall be the principal office of the Corporation.

Section 4 Notice of Meeting. Written notice stating the place, day and hour of the meeting and, in case of a special meeting, the purpose or purposes for which the meeting is called, shall be delivered not less than ten nor more than sixty days before the date of the meeting, either personally or by mail, by or at the direction of the Chairman of the Board, President, Secretary or the officer or other persons calling the meeting, to each shareholder of record entitled to vote at such meeting. If mailed, such notice shall be deemed to be delivered when deposited in the United States mail, addressed to the shareholder at his or her address as it appears on the stock transfer books of the Corporation, with postage thereon prepaid.

Section 5. Closing of Transfer Books or Fixing of Record Date. For the purpose of determining shareholders entitled to notice of or vote at any meeting of shareholders or any adjournment thereof, or shareholders entitled to receive payment of any dividend, or in order to make a determination of shareholders for any other proper purpose, the Board of Directors of the Corporation may provide that the stock transfer books shall be closed for a stated period but not to exceed, in any case, seventy days. If the stock transfer books shall be closed for the purpose of determining shareholders entitled to notice of or to vote at a meeting of shareholders, such books shall be closed for at least ten days immediately preceding such meeting. In lieu of closing the stock transfer books, the Board of Directors may fix in advance a date as the record date for any such determination of shareholders, such date in any case to be not more than seventy days and, in case of a meeting of shareholders, not less than ten days prior to the date on which the particular action, requiring such determination of shareholders, is to be taken. If the stock transfer books are not closed and no record date is fixed for the determination of shareholders entitled to notice of or to vote at a meeting of shareholders, or shareholders entitled to receive payment of a dividend, the date on which notice of the meeting is mailed or the date on which the resolution of the Board of Directors declaring such dividend is adopted, as the case may be, shall be the record date for such determination of shareholders. When a determination of shareholders entitled to vote at any meeting of shareholders has been made as provided in this section, such determination shall apply to any adjournment thereof

Section 6. Voting Record. The officer or agent having charge of the stock transfer books for shares of the Corporation shall make a complete record of the shareholders entitled to vote at each meeting of shareholders or any adjournment thereof, arranged in alphabetical order, with the address of and the number of shares held by each. Such record shall be produced and kept open at the time and place of the meeting and shall be subject to the inspection of any shareholder during the whole time of the meeting for the purposes thereof.

Section 7. Quorum. A majority of the outstanding shares of the Corporation entitled to vote, represented in person or by proxy, shall constitute a quorum at a meeting of shareholders. If less than a majority of the outstanding shares are represented at a meeting, a majority of the shares so represented may adjourn the meeting from time to time without further notice. At such adjourned meeting at which a quorum shall be present or represented, any business may be transacted which might have been transacted at the meeting as originally noticed. The shareholders present at a duly organized meeting may continue to transact business until adjournment, notwithstanding the withdrawal of enough shareholders to leave less than a quorum.

Section 8. Proxies. At all meetings of shareholders, a shareholder may vote in person or by proxy executed in writing by the shareholder or by his duly authorized attorney-in-fact. Such proxy shall be filed with the Secretary of the Corporation before or at the time of the meeting. No proxy shall be valid after eleven months from the date of its execution, unless otherwise provided in the proxy.

Section 9. Voting of Shares. Subject to the provisions of Section 12 of this Article II, each outstanding share entitled to vote shall be entitled to one vote upon each matter submitted to a vote at a meeting of shareholders.

Section 10. Voting of Shares by Certain Holders. Shares standing in the name of another corporation may be voted by such officer, agent or proxy as the By-Laws of such corporation may prescribe or, in the absence of such provision, as the Board of Directors of such other corporation may determine.

Shares held by an administrator, executor, guardian, committee, curator or conservator may be voted by him, either in person or by proxy, without a transfer of such shares into his name. Shares standing in the name of a trustee may be voted by him, either in person or by proxy, but no trustee shall be entitled to vote shares held by him without a transfer of such shares into his name.

Shares standing in the name of a receiver may be voted by such receiver, and shares held by or under the control of a receiver may be voted by such receiver without the transfer thereof into his name if authority so to do be contained in an appropriate order of the court by which such receiver was appointed.

A shareholder whose shares are pledged shall be entitled to vote such shares until the shares have been transferred into the name of the pledgee, and thereafter the pledgee shall be entitled to vote the shares so transferred.

Neither treasury shares of its own stock held by the Corporation, nor shares held by another corporation if a majority of the shares entitled to vote for the election of directors of such other corporation are held by the Corporation, shall be voted at any meeting or counted in determining the total number of outstanding shares at any given time for purposes of any meeting.

Section 11. Informal Action by Shareholders. Any action required or permitted to be taken at a meeting of the shareholders may be taken without a meeting if a consent in writing, setting forth the action so taken, shall be signed by all of the shareholders entitled to vote with respect to the subject matter thereof.

Section 12. Cumulative Voting. At each election for directors every shareholder entitled to vote at such election shall have the right to vote, in person or by proxy, the number of shares owned by him for as many persons as there are directors to be elected and for whose election he has a right to vote, or to cumulate his votes by giving one candidate as many votes as the number of such directors multiplied by the number of his shares shall equal, or by distributing such votes on the same principle among any number of such candidates.

ARTICLE III BOARD OF DIRECTORS

Section 1. General Powers. The business and affairs of the Corporation shall be managed by its Board of Directors.

Section 2. Number, Tenure and Qualifications. The number of directors of the Corporation shall be no more than twelve, no less than 1. Each director shall hold the office until the next annual meeting of shareholders and until his successor shall have been elected and qualified. Directors need not be not be residents of the State of West Virginia or shareholders of the Corporation.

Section 3. Regular Meetings. A regular meeting of the Board of Directors shall be held without other notice than this By-Law immediately after, and at the same place as, the annual meeting of shareholders. The Board of Directors may provide, by resolution, the time or place, either within or without the State of West Virginia, for the holding of additional regular meetings without other notice than such resolution.

Section 4. Special Meetings. Special meetings of the Board of Directors may be called by or at the request of the Chairman of the Board, if any, the President or any two directors. The person or persons authorized to call special meetings of the Board of Directors may fix any place, either within or without the State of West Virginia, as the place for holding any special meeting of the Board of Directors called by them

Section 5. Notice. Notice of any special meeting shall be given at least two days previously thereto by written notice delivered personally or mailed to each director at his business address, or by telegram. If mailed at least five days prior to the date of meeting, such notice shall be deemed to be delivered when deposited in the United States mail, so addressed, with postage thereon prepaid. If notice be given by telegram, such notice shall be deemed to be delivered when the telegram is delivered to the telegraph company. Any director may waive notice of any meeting. The attendance of a director at a meeting shall constitute a waiver of notice of such meeting, except where a director attends a meeting for the express purpose of objecting to the transaction of any business because the meeting is not lawfully called or convened. Unless otherwise provided by statute, neither the business to be transacted at, nor the purpose of, any regular or special meeting of the Board of Directors need be specified in the notice or waiver of notice of such meeting

Section 6. Quorum. A majority of the number of directors fixed by Section 2 of this Article III shall constitute a quorum for the transaction of business at any meeting of the Board of Directors, but if less than such majority is present at a meeting a majority of the directors present may adjourn the meeting from time to time without further notice.

Section 7. Manner of Acting. The act of the majority of the directors present at a meeting at which a quorum is present shall be the act of the Board of Directors

Section 8. Action Without a Meeting. Any action required or permitted to be taken by the Board of Directors at a meeting may be taken without a meeting if a consent in writing, setting forth the action so taken, shall be signed by all of the directors

Section 9. Vacancies. Any vacancy occurring in the Board of Directors may be filled by the affirmative vote of a majority of the remaining directors though less than a quorum of the Board of Directors. A director elected to fill a vacancy shall be elected for the unexpired term of his predecessor in office. Any directorship to be filled by reason of an increase in the number of directors may be filled by election by the Board of Directors for a term of office continuing only until the next election of directors by the shareholders.

Section 10. Compensation. By resolution of the Board of Directors, each director may be paid his expenses, if any, of attendance at each meeting of the Board of Directors, or committee thereof, and may be paid a stated salary as director or a fixed sum for attendance at each meeting of the Board of Directors or committee thereof or both. No such payment shall preclude any director from serving the Corporation in any other capacity and receiving compensation therefor.

Section 11. Presumption of Assent. A director of the Corporation who is present at a meeting of the Board of Directors at which action on any corporate matter is taken shall be deemed to have assented to the action taken unless he or she objects at the beginning of the meeting or promptly upon his or her arrival to holding or transacting business at the meeting, unless his dissent is entered in the minutes of the meeting, or unless he or she delivers written notice of his or her dissent to the presiding officer prior to the meetings adjournment or to the corporation immediately after adjournment Such right to dissent shall not apply to a director who voted in favor of such action.

Section 12. Telephonic Meetings. Meetings of the board of directors, whether regular or special, may be held by means of telephone conferences or equipment of similar communications by means of which all directors participating in the meeting can hear each other. Any vote of the directors in connection with any corporate action may be taken orally during any such telephonic meeting The result of any vote thus taken shall have like effect and validity as if reached by the voting directors at a meeting at which the directors were present in person if, either the result of such vote is reduced to writing and approved by the directors at their next meeting, or, in the case of a unanimous vote, the provisions of Section III.8 are followed

Section 13. Removal. Subject to the rights of any class or series of stock having a preference over the Common Stock as to dividends or upon liquidation to elect directors under the specified circumstances, any director elected by the holders of common stock may be removed from office, with or without cause, and only by the affirmative vote of the holders of a majority of the combined voting power of the then outstanding shares of stock entitled to vote generally in the election of such directors, voting together as a single class at a meeting called for the purpose of removing the director and for which notice of the meeting stated that the purpose, or one of the purposes of the meeting was removal of the director

ARTICLE IV OFFICERS

Section 1. Number. The officers of the Corporation shall be a President, one or more Vice Presidents (the number thereof to be determined by the Board of Directors), a Secretary and a Treasurer, each of whom shall be elected by the Board of Directors. A Chairman of the Board of Directors and such other officers and assistant officers as may be deemed necessary may be elected or appointed by the Board of Directors. Any two or more offices may be held by the same person The President and the Chairman of the Board, if any, shall be elected from the membership of the Board of Directors

Section 2. Election and Term of Office. The officers of the Corporation to be elected by the Board of Directors shall be elected annually by the Board of Directors at the first meeting of the Board of Directors held after each annual meeting of the shareholders. If the election of officers shall not be held at such meeting, such election shall be held as soon thereafter as conveniently may be. Each officer shall hold office until his successor shall have been duly elected and shall have qualified or until his death or until he shall resign or shall have been removed in the manner hereinafter provided.

Section 3 Removal. Any officer or agent may be removed by the Board of Directors, with or without cause, whenever in its judgment the best interests of the Corporation will be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed Election or appointment of an officer or agent shall not of itself create contract rights

Section 4 Vacancies. A vacancy in any office because of death, resignation, removal, disqualification or otherwise, may be filled by the Board of Directors for the unexpired portion of the term.

Section 5. Chairman of the Board and President. The Chairman of the Board or the President, as the Board of Directors may from time to time determine, shall be the principal executive officer of the Corporation. The principal executive officer of the Corporation shall in general supervise and control all of the business and affairs of the Corporation, subject to the control of the Board of Directors. He shall, when present, preside at all meetings of the shareholders. Whether the Chairman of the Board or the President be designated as the principal executive officer of the Corporation the other shall, in the absence or incapacity of the principal executive officer or by his authority may, exercise any of the powers of the principal executive officer. The Chairman of the Board or the President may sign deeds, mortgages, bonds, contracts or other instruments which the Board of Directors has authorized to be executed, except in cases where the signing and executing thereof shall be expressly delegated by the Board or by these By-Laws to some other officer or agent of the Corporation, or shall be required by law to be otherwise signed or executed. The Chairman of the Board and the President shall each, in general, perform all duties incident to their respective offices and shall perform such other duties as may be prescribed by the Board of Directors from time to time.

Section 6. The Vice Presidents. In the absence of the Chairman of the Board and President or in the event of their death, inability or refusal to act, the Vice President (or in the event there be more than one Vice President, the Vice Presidents in the order designated at the time of their election, or in the absence of any designation, then in the order of their election) shall perform the duties of the Chairman of the Board and President, and when so acting shall have all the powers of and be subject to all the restrictions upon the Chairman of the Board and President. Any Vice President may sign, with the Secretary or an Assistant Secretary, certificates for shares of the Corporation and shall perform such other duties as from time to time may be assigned to him by the principal executive officer of the Corporation, the By-Laws or the Board of Directors

Section 7. The Secretary. The Secretary shall: (a) keep the minutes of the proceedings of the shareholders and of the Board of Directors in one or more books provided for that purpose; (b) see that all notices are duly given in accordance with the provisions of these By-Laws or as required by law; (c) be custodian of the corporate records and of the seal of the Corporation and see that the seal of the Corporation is affixed to all documents and execution of which, on behalf of the Corporation under its seal, is duly authorized; (d) keep a register of the post office address of each shareholder which shall be furnished to the Secretary by such shareholder; (e) sign with the President, or a Vice President, certificates for shares of the Corporation, the issuance of which shall have been authorized by resolution of the Board of Directors; (f) have general charge of the stock transfer books of the Corporation; and (g) in general perform all duties incident to the office of Secretary and such other duties as from time to time may be assigned to him by the principal executive officer of the Corporation, the By-Laws or by the Board of Directors

Section 8. The Treasurer. The Treasurer shall: (a) have charge and custody of and be responsible for all funds and securities of the Corporation; (b) receive and give receipts for monies due and payable to the Corporation from any source whatsoever and deposit all such monies in the name of the Corporation in such banks, trust companies or other depositaries as shall be selected in accordance with the provisions of Article V of these By-Laws; and (c) in general perform all of the duties incident to the office of Treasurer and such other duties as from time to time may be assigned to him by the principal executive officer of the Corporation, the By-Laws or by the Board of Directors. If required by the Board of Directors, the Treasurer shall give a bond for the faithful discharge of his duties in such sum and with such surety or sureties as the Board of Directors shall determine

Section 9. Assistant Secretaries and Assistant Treasurers. The Assistant Secretaries, when authorized by the Board of Directors, may sign with the President or a Vice President certificates for shares of the Corporation, the issuance of which shall have been